



1986

Tax Policy: Copyrights and Patents

Madelyn Shohen Cantor

Follow this and additional works at: <https://digitalcommons.law.villanova.edu/vlr>



Part of the [Intellectual Property Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Madelyn S. Cantor, *Tax Policy: Copyrights and Patents*, 31 Vill. L. Rev. 931 (1986).

Available at: <https://digitalcommons.law.villanova.edu/vlr/vol31/iss3/4>

This Article is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository.

1986]

TAX POLICY: COPYRIGHTS AND PATENTS*

MADELYN SHOEN CANTOR†

TABLE OF CONTENTS

I. INTRODUCTION	932
II. CURRENT LAW	937
A. <i>Characterization</i>	937
1. <i>What is a Capital Asset?</i>	937
2. <i>Other Factors Which Determine Characterization</i>	945
B. <i>Provisions Other than Section 1235 which Specifically</i> <i>Benefit Inventors</i>	968
III. LEGISLATIVE HISTORIES	974
A. <i>Capital Gain Concept</i>	974
B. <i>The Revenue Act of 1950: Exclusion of Copyrights from</i> <i>Definition of Capital Asset</i>	976
C. <i>The Internal Revenue Code of 1954: Sale or Exchange</i> <i>of Patents</i>	984
IV. WHY SUCH TREATMENT?	987
A. <i>Congressional Power to Issue Copyrights and Patents</i> <i>Arises from Same Constitutional Grant</i>	987

* Editor's note:

The Tax Reform Act of 1986 modifies some of the analysis in this paper to the extent that the Act repeals the net capital gains deduction. However, the Act leaves in place those provisions which delineate the characterization of an asset. Also, the advantage which permits recognized capital losses to be deducted to the extent of capital gains remains in the code. For example, if an asset receives capital characterization under the code, then upon an income producing exchange the taxpayer will realize capital gain. This capital gain may later be offset by any capital loss carried forward which the taxpayer may have plus \$3000. Only after the capital losses are deducted to the extent of the capital gains is the gain taxed. But, if the asset or the transaction is characterized as ordinary, then upon an income producing exchange all of the gain must be recognized and taxed. None of this ordinary gain may be offset by any capital losses. Also, since the social security tax is based upon compensation income, any capital gains would, in most instances not be subject to the social security tax, whereas the ordinary income of the artist would be so treated.

Thus, Congress continues to follow its policy of preferential treatment towards those assets which are characterized as capital. Patents are capital assets. Copyrights are not. This policy of preferential treatment towards patents as opposed to copyrights is the thesis of this paper.

† J.D., Villanova University School of Law, 1985. Ms. Cantor was awarded a cash prize for this paper by the American Counsel of Tax Policy. The paper placed as a runner-up in the annual writing competition held by the American Journal of Tax Policy.

(931)

B.	<i>Both Patents and Copyrights Result from Personal Efforts of Creator</i>	988
C.	<i>Differences in Tax Treatment Due to Ad hoc Reactions to Political and Economic Events</i>	989
D.	<i>Contrivances Needed by Holders of Copyrighted Property to Get Long-term Capital Gain Treatment</i>	990
E.	<i>Tax Risks in Seeking Classification</i>	996
V.	POSSIBLE SOLUTIONS TO THE I.R.C. SECTION 1235 INEQUITY	999
VI.	CONCLUSION	1003

I. INTRODUCTION

CONGRESS, in the Internal Revenue Code¹ ("I.R.C." or "Code"), discriminates against authors,² artists, composers, and other individuals entitled to copyright protection. These taxpayers are denied the preferential treatment of a deduction for capital gains³ which would permit them to deduct from their gross income sixty percent of the net capital gain⁴ resulting from

1. 26 U.S.C. §§ 1-9602 (1982 & Supp. III 1985).

2. Throughout this article the terms "author" and "artist" are used interchangeably to mean the creator of a work or performance which is entitled to copyright protection under either copyrights, Pub. L. No. 94-553, 90 Stat. 2541 (1976) (codified as amended at 17 U.S.C. §§ 101-914 (1982 & Supp. III 1985)) or the common law. "Author" is the term used in the Constitutional grant of power to Congress. See U.S. CONST. art. I, § 8, cl. 8. For a further discussion of the broad application of the term "author," see 1 M. B. NIMMER, NIMMER ON COPYRIGHT § 1.06[A], n.2 (1986).

3. The deduction for capital gains, as set forth in section 1202 of the Internal Revenue Code, provides in pertinent part:

(a) In general—If for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income.

(c) Transitional Rule—If for any taxable year ending after October 31, 1978, and beginning before November 1, 1979, a taxpayer other than a corporation has a net capital gain, the deduction under subsection (a) shall be the sum of—

(1) 60 percent of the lesser of—

(A) the net capital gain for the taxable year, or
(B) the net capital gain taking into account only gain or loss property taken into account for the portion of the taxable year after October 31, 1978, plus

(2) 50 percent of the excess of—

(A) the net capital gain for the taxable year, over
(B) the amount of net capital gain taken into account under paragraph (1).

I.R.C. § 1202 (1982).

4. The term "net capital gain" is defined by the Internal Revenue Code to be "the excess of the net long-term capital gain for the taxable year over the net

a sale of their works. Authors instead must declare the income from the sale of their works or performances as ordinary income and pay the "full tax."⁵ Inventors and patentees, on the other hand, may take the capital gains deduction upon a sale or exchange of their invention.⁶ Although the works of both inventors

short-term capital loss for such year." I.R.C. § 1222(11) (1982). Section 1222(3) defines "long-term capital gain" to be "gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income." I.R.C. § 1222(3) (Supp. III 1985). Section 1222(2) defines short-term capital loss to be "loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent that such loss is taken into account in computing taxable income." I.R.C. § 1222(2) (Supp. III 1985).

5. Professor Blum defines "full tax" to mean the amount due if all of the taxpayer's income is taxed as ordinary and none of it qualifies for any deductions. Blum, *The Effects of Special Provisions in the Income Tax on Taxpayer Morale*, Joint Committee on Economic Growth and Stability 251 (1955), reprinted in *READINGS IN FEDERAL TAXATION*, 41, 42 (F. Sander and D. Westfall eds. 1970).

6. See I.R.C. § 1235 (1982 & Supp. III 1985). This section specifically provides:

(a) General.—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

- (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or
- (2) contingent on the productivity, use, or disposition of the property transferred.

(b) "Holder" defined.—For purpose of this section, the term "holder" means—

- (1) any individual whose efforts created such property, or
- (2) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—
 - (A) the employer of such creator, nor
 - (B) related to such creator (within the meaning of sub-

section (d)).

(c) Effective Date.—This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) Related Persons.—Subsection (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267(b) or persons described in section 707(b); except that, in applying section 267(b) and (c) and section 707(b) for purposes of this section—

(1) the phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in section 267(b) or 707(b) and

(2) paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

and authors are the result of the personal efforts of these persons, Congress specifically excludes from the definition of a capital asset those works of art which are held by "a taxpayer whose *personal efforts* created such property,"⁷ and then, in most contradictory fashion, specifically states that inventions in the hands of the "individual whose *efforts* created such property"⁸ are to be given capital gain treatment.

To fully comprehend the discrimination against authors and others who are entitled to copyright protection,⁹ one must first examine the provisions of the Internal Revenue Code that provide for the preferential treatment of long-term capital gain, and then decide whether those preferences are justified.

The legislators conferred a preference upon some taxpayers through the capital gains provisions of the Code. Section 1221 defines the term "capital asset" as property held by the taxpayer and it then lists specific exclusions from that definition.¹⁰ Copyrighted property held by its creator or his donee or benefactor is specifically excluded.¹¹ Because such property is not considered to be a capital asset, these taxpayers cannot take advantage of section 1202 of the Code in order to have the gain resulting from an exchange of the property characterized as a long-term capital gain.¹² Hence, they are denied the benefits of a capital gain deduction as allowed by section 1202.

Inventions held by their creators, however, are not excluded from the definition of capital assets. In fact, in section 1235 of the Internal Revenue Code,¹³ Congress specifically states that inventions, patents and designs are to be characterized as capital as-

Id.

7. I.R.C. § 1221(3)(A) (1982) (emphasis added). For the complete text of section 1221, see *infra* note 28.

8. I.R.C. § 1235(b)(1) (1982) (emphasis added). For the complete text of section 1235(b)(1), see *supra* note 6.

9. See generally 17 U.S.C. §§ 101-914 (1982 & Supp. III 1985).

10. See, e.g., I.R.C. § 1221(3) (1982). For the full text of section 1221, see *infra* note 28.

11. I.R.C. § 1221(3) (1982). For the full text of section 1221(3), see *infra* note 28.

12. I.R.C. § 1222(3) (Supp. III 1985). For the text of section 1222(3), see *supra* note 4.

The Deficit Reduction Act of 1984 reduced the holding period from one year to six months plus one day for assets acquired after 6/22/84 and before 1/1/88. Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified at I.R.C. § 1222(1)-(4) (Supp. III 1985)); H.R. REP. No. 861, 98th Cong., 2d Sess. 757, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1952.

13. For the full text of section 1235, see *supra* note 6.

sets.¹⁴ Furthermore, under this section, patentees or inventors receive additional preferential treatment which is denied to other taxpayers who transfer capital assets.¹⁵

There are other discriminations in the Code which are biased against authors and artists. For example, section 1231 specifically excludes copyright property held by its creator from the definition of trade or business property even though copyrights can be depreciable property.¹⁶ Also, the author and the artist meet with great difficulty when either tries to establish that he is carrying on the trade or business of writing or creating visual art in order to take advantage of various deductions and other treatment allowed only to those carrying on a trade or business.¹⁷

As a counterpoise to the difficulties that artists have, the Code contains other sections which further benefit inventors and patentees. Section 174, for example, permits the inventor to deduct or amortize his research and experimental expenditures,¹⁸

14. I.R.C. § 1235(a) (Supp. III 1985). For the full text of section 1235, see *supra* note 6.

15. I.R.C. § 1235 (1982 & Supp. III 1985). Under section 1235, for example, both *amatuer* and *professional* inventors realized long-term capital gains. See generally 3B J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 22.134 (1980 Rev. Vol.). For a further discussion of this treatment, see *infra* note 49 and accompanying text.

Also, under section 1235, the traditional section 1222 holding period is not required in order to realize long-term capital gain. For a further discussion of this preference, see *infra* notes 51-52 and accompanying text. Finally, under section 1235, payments received, whether in the form of a contingent payment or a periodic payment, are deemed a sale, therefore qualifying under section 1222 as a sale of a capital asset. Such a transfer amounts to a license under other sections of the Code. For a further discussion of this preference, see *infra* note 53 and accompanying text.

16. I.R.C. § 1231(b)(1)(C) (1982 & Supp. III 1985). Section 1231(b)(1)(C) defines "property used in the trade or business" as:

property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, *which is not a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property*, held by a taxpayer

Id. (emphasis added). For a discussion of the effect of The Deficit Reduction Act of 1984 on this holding period, see *supra* note 12.

17. See generally A. FELD, M. O'HARE, J. SCHUSTER, *PATRONS DESPITE THEMSELVES: TAXPAYERS AND ARTS POLICY* 16 (1983); Lerner, *Planning the Collector's Estate*, in *REPRESENTING ARTISTS, COLLECTORS, AND DEALERS* 17 (1983).

18. I.R.C. § 174(a) (1982). In pertinent part, this section specifically provides that "[a] taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction." *Id.*

and section 30 provides a credit for these expenditures.¹⁹ Furthermore, in a patent infringement case, the patentee may treat the damage payments as payment for the transfer of a capital asset.²⁰

The legislative histories which accompany the enactment of these provisions indicate the reasons why Congress has so acted. These histories manifest a policy of blatant favoritism for small business and industry.²¹ In contrast, Congress took "loophole-closing measures" with respect to any advantages of which the artist or author may have availed himself.²²

These discriminations in the Code are unjustified for several reasons. First, Congress gets its authority to make laws to benefit authors and inventors from the same constitutional grant.²³ Second, both patented and copyrighted property are the result of the personal efforts of their respective creators. And third, upon close examination, the differences in the treatment to each are largely due to legislation based on ad hoc reactions to political and economic events.²⁴

As a result of the discrepancies in the tax code, the artist

19. I.R.C. § 30 (Supp. III 1985) (renumbering I.R.C. § 44F (1982)). For a full text of I.R.C. § 30, see *infra* note 172.

20. See Treas. Reg. § 1.1235-1(c)(1) (1960). This regulation provides: *Payments for Infringement.* If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. For taxable years beginning January 1, 1964, see section 1304, as in effect before such date, and § 1.1304a-1 for treatment of compensatory damages for patent infringement.

Id.

21. See, e.g., S. REP. NO. 2375, 81st Cong., 2d Sess., reprinted in 1950 U.S. CODE CONG. & AD. NEWS 3053, 3221-22; H. REP. NO. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4025, 4026. For a further discussion of Congress' blatant favoritism toward small businesses as manifested in the legislative histories of the tax code, see *infra* notes 186-95 & 202-13 and accompanying text.

22. See, e.g., S. REP. NO. 2375, 81st Cong., 2d Sess., reprinted in 1950 U.S. CODE CONG. & AD. NEWS 3053, 3097. For a further discussion of these "loophole-closing measures," see *infra* notes 194-219 and accompanying text.

23. U.S. CONST. art. I, § 8, cl. 8 provides that: "The Congress shall have the Power . . . [t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." *Id.* For a further discussion of the Constitutional grant of power, see *infra* note 246 and accompanying text.

24. See Mott, *Authors' Tax Problems—A Summary of the Provisions of the Internal Revenue Code*, 22 FED. B.J. 148, 150 (1962); Note, *A Comparison of the Tax Treatment of Authors and Inventors*, 70 HARV. L. REV. 1419, 1423 (1957).

must resort to contrivances such as the creation of contract rights²⁵ or the formation of corporations²⁶ in hopes of realizing long-term capital gains. Although these contrivances have worked for performing artists, it is uncertain whether they will work for visual artists.²⁷

To resolve the inequities of I.R.C. section 1235, Congress could enact legislation for artists and authors which would be similar to section 1235 or, alternatively, it could revise section 1235 to include artists. Another resolution could be to provide long-term capital gain treatment for the artist to the extent of the appreciation which has occurred while he held his creation. Finally, Congress could repeal section 1235.

II. CURRENT LAW

A fair analysis of the discrimination against artists, authors, and other copyright creators can best be made when one fully understands the tax atmosphere. Therefore, a detailed explanation of the current state of the relevant law ensues.

A. Characterization

1. *What is a Capital Asset?*

To begin this analysis, one must clarify exactly what constitutes a capital asset. The Internal Revenue Code defines a capital asset in section 1221 as property held by the taxpayer, whether or not connected with his trade or business, unless specifically excluded.²⁸ Technically, then, all property is a capital asset unless

25. See, e.g., *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *Benny v. Commissioner*, 25 T.C. 197 (1955). For a further discussion of the *Ferrer* case, see *infra* notes 87-106, 137-42, 145-46 & 257 and accompanying text. For a further discussion of the *Benny* case, see *infra* notes 258-60 and accompanying text.

26. See, e.g., *Estate of Cole*, 32 T.C.M. 313 (CCH) (1973); *Benny v. Commissioner*, 25 T.C. 617 (1961). For a further discussion of the *Cole* case, see *infra* notes 264-72 and accompanying text. For a further discussion of the *Benny* case, see *infra* notes 258-60 and accompanying text.

27. For a further discussion of the problems faced by visual artists in attempting to take advantage of contrivances in the hopes of realizing long-term capital gains, see *infra* notes 277-80 and accompanying text.

28. I.R.C. § 1221 (1982). This section provides:

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer

the Code states otherwise.²⁹

Specifically excluded in section 1221(3) from the definition of a capital asset are copyrights, literary, musical, or artistic compositions, letters or memoranda, or "similar property," if these properties: (1) are held by the taxpayer whose personal efforts created the property; or (2) in the case of letters or memoranda, are held by the person for whom they were created; or (3) are held by a taxpayer in whose hands the basis of the property is determined by reference to the creator's basis (i.e. gift and like kind exchanges).³⁰ The Internal Revenue Service ("Service" or "I.R.S."), in clarifying what is meant by the term "similar property," points out in the regulations that this term does not include a patent for an invention, but rather includes theatrical productions, radio programs, newspaper cartoon strips, "or any other property eligible for copyright protection."³¹

primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, or a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

Id.

29. The Treasury Regulations repeat this warning. *See* Treas. Reg. § 1.1221-1(a) (1960). In relevant part, this regulation provides that "[t]he term 'capital assets' includes all classes of property not specifically excluded by section 1221." *Id.*

30. I.R.C. § 1221(3) (1982). For the full text of section 1221(3), see *supra* note 28.

31. Treas. Reg. § 1.1221-1(c)(1), T.D. 7369, 1975-2 C.B. 335, 336. The regulation specifically provides that:

A copyright, a literary, musical, or artistic composition, and similar

The Service, in the regulations, also clarifies the term “personal efforts” as used in section 1221(3).³² A taxpayer creates property by his personal efforts if he “performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work.”³³

Even if there were no specific exclusion in section 1221(3), copyrights and other similar property still could not be classified as capital assets if they were held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business because of section 1221(1).³⁴ Nor would these assets be considered capital assets if they were depreciable property used in a trade or

property are excluded from the term “capital assets” if held by a taxpayer whose personal efforts created such property or if held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, the phrase “similar property” includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

Id.

32. See Treas. Reg. § 1.1221-1(c)(3), T.D. 7369, 1975-2 C.B. 335, 336.

33. *Id.* The regulation specifically provides:

For purposes of this paragraph, in general, property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as a corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

Id.

34. I.R.C. § 1221(1) (1982). Section 1221(1) provides that the term “capital asset” does not include stock in trade or property that would normally be considered as inventory if on hand at the end of a taxable year or property that is primarily held for sale to customers in the ordinary course of the taxpayer’s business. *Id.* For the text of section 1221(1), see *supra* note 28.

business because of section 1221(2).³⁵

Patents and inventions, however, are not specifically excluded from the definition of a capital asset under section 1221. And the Service, to obviate any confusion as to legislative intent to keep these assets within the definition of a capital asset, declares that a patent or an invention is not to be considered "similar property."³⁶ Therefore, an invention will not be excluded even if it is held by the taxpayer whose personal efforts created it.

The Internal Revenue Code makes it quite clear in section 1235 that individual inventors and their financial backers can obtain long-term capital gain treatment on a transfer of patent rights.³⁷ To qualify under section 1235, the transfer may not be to a related person, nor may it be by gift or inheritance.³⁸ The individual must also be the "holder" of the transferred patent right, thereby precluding the application of section 1235 to corporations.³⁹ Congress specifically defines "holder" in this section to mean one "whose efforts created such property,"⁴⁰ or his financial backers (who are neither his employers nor related to the creator).⁴¹ The Treasury Regulations further define "holder" to include one who is the "'original and first' inventor."⁴² Ironi-

35. I.R.C. § 1221(2) (1982). Section 1221(2) provides that excluded from the term "capital asset" is property used in the taxpayer's trade or business which is subject to the depreciation allowance provided in section 167, or that is real property. *Id.*

Normally, when a taxpayer's property is excluded from the capital asset definition under section 1221 because it is depreciable, the taxpayer can alternatively rely on section 1231 in an attempt to have a sale or exchange of the property recognized as a capital one. Copyrights as described in section 1221(3), however, are specifically excluded from the possible benefits of section 1231. *See* I.R.C. § 1231(b)(1)(C) (1982 & Supp. III 1985). Here again is another specific Code discrimination against copyrights which does not apply to patents. For the full text of section 1221, see *supra* note 28.

36. Treas. Reg. § 1.1221-1(c)(1), T.D. 7369, 1975-2 C.B. 335, 336. For the text of Treas. Reg. § 1.1221-1(c)(1), see *supra* note 31.

37. I.R.C. § 1235 (1982 & Supp. III 1985). For the full text of section 1235, see *supra* note 6.

38. I.R.C. §§ 1235(b)(2)(B) (1982), 1235(a) (Supp. III 1985). For the text of §§ 1235(b)(2)(B) and 1235(a), see *supra* note 6.

39. I.R.C. §§ 1235(a), 1235(b) (1982 & Supp. III 1985). For the text of §§ 1235(a) and 1235(b), see *supra* note 6.

40. I.R.C. § 1235(b)(1) (1982). For the text of § 1235(b)(1), see *supra* note 6.

41. I.R.C. § 1235(b)(2) (1982). For the text of § 1235(b)(2), see *supra* note 6.

42. *See* Treas. Reg. § 1.1235-2(d)(1)(i) (1960). This regulation provides that "[t]he term 'holder' means any individual: [w]hose efforts created the patent property and who would qualify as the 'original and first' inventor, or joint inventor, within the meaning of title 35 of the United States Code" *Id.* (emphasis added).

cally, Congress, in the definition of the term “holder,” makes a blatant contradiction with section 1221. A patent held by the individual whose *efforts* created such property is a capital asset under section 1235,⁴³ while a copyright held by the taxpayer whose *personal efforts* created it is specifically excluded from the definition of a capital asset in section 1221.⁴⁴

Furthermore, in the Treasury Regulations the Service extended the application of section 1235 to inventions, as well as patents, stating that they also qualify for long-term capital gain treatment. To take advantage of section 1235, it is not necessary that a patent or even a patent application be in existence provided the inventor is able to meet the other requirement of the section.⁴⁵ A transfer of know-how also comes under the rubric of section 1235.⁴⁶

Under section 1235, the individual holder must also transfer

43. I.R.C. § 1235(b)(1) (1982). For the full text of § 1235(b)(1), see *supra* note 6.

44. I.R.C. § 1221(3)(A) (1982). For the text of § 1221(3)(A), see *supra* note 28.

45. See Treas. Reg. § 1.1235-2(a) (1960). This regulation specifically provides that:

For the purposes of section 1235 and section 1235-1: *Patent*. The term “patent” means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

Id.

46. See Morreale, *Patents, Know-How and Trademarks: A Tax Overview*, 29 TAX LAW. 553 (1976). Mr. Morreale defines the term “Know-how” to refer “to any compilation of information used in a business that gives the user an opportunity to gain an advantage over competitors who do not know about or use such information.” *Id.* at 564. Mr. Morreale argues that

[s]ales of know-how will produce capital gains as long as the know-how constitutes property and is a capital asset in the hands of the seller. The apparent Service position is that only know-how that is secret and protectible against disclosure, at least in significant part, can qualify as “property” within the meaning of section 1221. The courts, however, ordinarily take a less restrictive view of whether know-how constitutes property, and it would appear that know-how need not necessarily be a trade secret in order to qualify as property. For example, a valuable process known only to a few companies in a large industry should be treated as property, as should an indexed compilation of technical information relating to a process known by several companies. Finally, in a combined transfer of patents and know-how, the know-how may be so incidental or ancillary to the patent as to be deemed to have taken on the “property” character of the transferred patent.

Id. at 565 (footnotes omitted); see also Cohen, *Capital Gains and the Sale of Know-How*, 60 TAXES 601 (1982); Harding, *Obtaining Capital Gains Treatment on Transfers of Know-How*, 37 TAX LAW. 307 (1984).

"all substantial rights" to the patent or invention.⁴⁷ The Regulations cite factors which are to be considered in determining whether all substantial rights have been transferred.⁴⁸ A mere licensing of patent rights will not qualify under this section.

It is unimportant, under section 1235, whether the inventor is a professional or an amateur.⁴⁹ And it is also immaterial

47. I.R.C. § 1235(a) (Supp. III 1985). For the text of § 1235(a), see *supra* note 6.

48. Treas. Reg. § 1.1235-2(b), T.D. 6852, 1965-2 C.B. 289, 290 provides:

All substantial rights to a patent. (1) The term "all substantial rights to a patent" means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term "all substantial rights to a patent" does not include a grant of rights to a patent:

(i) Which is limited geographically within the country of issuance;

(ii) Which is limited in duration by the terms of the agreement to a patent less than the remaining life of the patent;

(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of section 1235.

Id. For a discussion of the restrictions on patent licensing, see generally Morreale, *supra* note 46, at 558-60.

49. According to section 1235, capital gains tax treatment is available to any transfer of property made by a "holder." A holder is defined as "any individual whose efforts created such property," or "any other individual who has acquired his interest in such property in exchange for consideration" I.R.C.

whether the taxpayer is holding his patent or invention for sale to customers in the ordinary course of business.⁵⁰

Furthermore, under section 1235, there is no holding period requirement for the individual holder to receive long-term capital gain treatment. The section states that a transfer of all substantial rights to a patent "by any holder shall be considered the sale or exchange of a capital asset held for more than six months."⁵¹ As such, an inventor enjoys greater preferences under the Code than an ordinary investor who must meet the "more than six months" holding period requirement of I.R.C. section 1222(3) for assets acquired after June 22, 1984 and before January 1, 1988 in order to realize long-term capital gain.⁵²

Section 1235 also states that the transfer of a patent or invention shall be considered a sale or exchange "regardless of whether or not payments are . . . payable periodically . . . or contingent on the productivity, use, or disposition of the property transferred."⁵³ Once again, the inventor enjoys a greater preference than an ordinary taxpayer because an ordinary taxpayer who receives contingent or periodic payments for his capital asset is usually not able to meet the "sale" requirement of I.R.C. section 1222 if the asset itself does not pass to the payor.

As if Congress has not given inventors enough of an incentive with the enactment of I.R.C. section 1235, the Service, in the Treasury Regulation to that section, has also stated that any damage payments awarded for patent infringement "shall be considered payments attributable to a transfer to which section 1235 applies."⁵⁴

Finally, section 1235 is non-exclusive. The regulations state that if section 1235 does not apply, e.g., because the transfer is to

§ 1235(b) (1982) (emphasis added). For the full text of section 1235(b), see *supra* note 6. See also 3B J. MERTENS, *supra* note 15, at 918 (with respect to capital gain treatment in favor of a holder of patent or invention, unimportant whether taxpayer is professional or amateur inventor, or whether taxpayer holds the patent or invention for sale to customers in ordinary course of trade or business).

50. Section 1235 contains no language regarding the purpose for which the taxpayer holds the patent. For the full text of section 1235, see *supra* note 6. See also 3B J. MERTENS, *supra* note 15, at 918.

51. I.R.C. § 1235(a) (Supp. III 1985). For the full text of section 1235(a), see *supra* note 6.

52. I.R.C. § 1222(3) (Supp. III 1985); see H.R. REP. NO. 861, 98th Cong., 2d Sess. 757, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 1445, 1952.

53. I.R.C. § 1235(a) (Supp. III 1985). For the full text of section 1235(a), see *supra* note 6.

54. See Treas. Reg. § 1.1235-1(c)(1) (1960). For the text of Treas. Reg. § 1.1235-1(c)(1), see *supra* note 20.

a related person, then the tax consequences of the transfer are to be governed by the other provisions of the Code.⁵⁵ The Service reiterated this point in Revenue Ruling 69-482, stating that if section 1235 does not apply, a taxpayer may still be able to get long-term capital gain treatment under the other provisions in the Code.⁵⁶ For example, since patents are depreciable assets, section 1231 could apply to characterize the transaction as long-term capital gain. However, if the taxpayer fails to meet the requirements of section 1235 and resorts instead to section 1231 for capital gain characterization, he must still meet the requirements of section 1231.⁵⁷

After I.R.C. section 1235 was passed in 1954, Revenue Ruling 55-58 was issued which failed to give the section retroactive

55. Treas. Reg. § 1.1235-1(b) (1960). This regulation pertains to the scope of I.R.C. § 1235 and provides:

If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

Id.

56. Rev. Rul. 69-482, 1969-2 C.B. 164. In this ruling, the taxpayer, who was a "holder" as that term is defined in section 1235(b) of the Code, transferred all substantial rights in a patent to a corporation in which he owned one-third of the outstanding stock. The corporation was making payments for the patent as provided by section 1235 of the Code. In the hands of the taxpayer, the patent was a capital asset.

Reasoning that the transfer in question was to a corporation that is a related person within the meaning of section 1235(d), the I.R.S. determined that the transaction did not meet the requirements of section 1235 and, therefore, was not eligible for long-term capital gains treatment.

The I.R.S. further stated, however, that the taxpayer was "entitled to treat the transfer of all substantial rights in the patent as the sale or exchange of a capital asset and the gain therefrom is reportable as long-term capital gain." *Id.* at 165. The Service's rationale for this holding was that "the mere fact that a patent transfer by a holder for contingent amounts does not qualify for long-term capital gains treatment under section 1235 of the Code, will not prevent it from qualifying for such treatment under other provisions of the Code if it would qualify for such treatment in the absence of section 1235." *Id.*

57. See D. POSIN, FEDERAL INCOME TAXATION OF INDIVIDUALS 244-45 (1983); see also 7 FED. TAXES (P-H) ¶ 32,105 (1986), which states in relevant part that

[u]nder Sec. 1235, . . . individual inventors and certain other individual holders of patents can obtain long-term capital gain for patent right transfers that qualify under that provision. . . . If Sec. 1235 rules don't apply, the patent rights must be capital assets (in general, held for investment) or Sec. 1231 assets (in general, depreciable property used in business and held for the long-term period . . .) and their transfer must qualify as a sale or exchange, to produce capital or Sec. 1231 gain or loss.

Id.

effect to May 31, 1950.⁵⁸ The Tax Court, however, has liberally construed section 1235.⁵⁹

2. *Other Factors Which Determine Characterization*

The question of why Congress gave patentees and inventors such preferential treatment has been raised by many scholars of the Internal Revenue Code.⁶⁰ A discussion of the legislative histories of the pertinent code sections suggests some possible theories. However, before those histories are presented, other relevant factors that may determine characterization must first be discussed.

Transfer of a Property Right

The taxpayer must transfer an item that amounts to a property right if it is to be considered a capital asset transfer. Certain items that represent rights to future income are not treated as capital assets and the payment which a taxpayer receives for them may be considered either wholly or partially as compensation for services, instead of proceeds from the sale of a capital asset.⁶¹

58. Rev. Rul. 55-58, 1955-1 C.B. 97. This ruling dealt with the issue of what treatment will be given to amounts received by investors from the assignment of patents, or the exclusive right to make, use and sell patented articles under license agreements, where such amounts are not subject to section 1235. *Id.* The Service ruled that:

Although section 1235 of the Internal Revenue Code of 1954 specifically provides that, with specified exceptions, such payments received in 1954 and subsequent years will receive capital gains treatment in the hands of the inventor, this provision of the 1954 Code is applicable only to amounts received in taxable years beginning after December 31, 1953, and therefore does not apply to amounts received in taxable years beginning after May 31, 1950, and before January 1, 1954.

Accordingly, except as section 1235 of the Internal Revenue Code of 1954 applies, the Internal Revenue Service will continue to treat as ordinary income the payments received by inventors during taxable years beginning May 31, 1950, from such transfers.

Id.

59. See *Rouverol v. Commissioner*, 42 T.C. 186 (1964). In *Rouverol*, a taxpayer had entered into a written agreement in which he granted to a firm "an exclusive right and license, with right to sublicense . . ." a transmission which he had invented and patented. *Id.* at 187. The firm granted further licenses to another firm. *Id.* at 189. The court held that the income received for the transfers was taxable as long-term capital gain rather than as ordinary income. *Id.* at 194.

60. See generally Eulenberg, *Books and Mousetraps*, 54 A.B.A. J. 1173 (1968); Pilpel, *Development in the Tax Law Affecting Copyrights in 1954*, 33 TAXES 271 (1955) [hereinafter cited as *Development in the Tax Law*]; Pilpel, *Tax Law Affecting Copyrights: 1954-56*, 35 TAXES 76 (1957) [hereinafter cited as *Tax Law*]; Note, *supra* note 24.

61. 7 FED. TAXES (P-H) ¶ 32,091 (1984). Courts have used three factors to

The courts often use assignment of income principles⁶² to deny capital gain treatment to a particular transaction because it is not a transfer of a property right but rather a transfer of a right to future income.⁶³ In the copyright area, these principles are often

determine the capital (or ordinary) character of gain or loss from a transaction. First, a sale of an entire business for a single price (i.e. a sale of all the going concern assets of a business as distinguished from the sale of the stock of a corporation that operates it) is treated as a separate sale of assets and the taxpayer may have a part capital gain or loss and a part ordinary gain or loss on the transaction. Second, property that would be a capital asset may be treated as an ordinary asset if bought solely in connection with a business (e.g. stock of a supplier concern). And third, certain items transferred are not capital assets but rather ordinary income. These transferred items represent rights to future income, the payments of which are treated as compensation for services. For examples of transfers treated as rights to future income and therefore ordinary income, see, e.g., *Bellamy v. Commissioner*, 43 T.C. 487 (1965) (actor had ordinary income on sale of contract right to distribute and show films; investment in films was only a service); *Bessie Lasky v. Commissioner*, 22 T.C. 13 (1954) (assignment of right to receive motion picture royalties results in ordinary income), *petition for review dismissed*, 235 F.2d 97 (9th Cir. 1956), *aff'd per curiam*, 302 U.S. 1027 (1957); *McFall v. Commissioner*, 34 B.T.A. 108 (1936) (employee had ordinary income on "sale" of employment contract to third party acting under agreement with employer).

62. Assignment of income involves the transfer of income from one taxpayer to another before that income is received. The assignment of income doctrine dictates that where the right to receive income is transferred to another person in a transaction which does not give rise to a tax at the time of the transfer, the transfer is taxed on the income when it is collected by the transferee. See D. POSIN, *supra* note 57, at 266-82. There are two types of such assignments. Gratuitous assignments involve situations where a cash method taxpayer who is owed compensation for personal services he has rendered attempts to assign the payment of that compensation to a family member. *Id.* at 266.

This was the case in *Lucas v. Earl*, 281 U.S. 111 (1930), when a taxpayer agreed by contract to assign his wife one-half of all his future earnings. *Id.* at 113-14. The taxpayer argued that although he earned the income, his wife should be taxed on the half assigned to her. *Id.* at 114. The purpose of such assignments are to decrease the tax on the overall family unit because the donee will be in a lower tax bracket than the donor. See D. POSIN, *supra* note 57, at 266. However, the Supreme Court held that salaries should be taxed to those who earn them and the wage-earner cannot escape this tax by an anticipatory contract which provides that the salary be paid to someone else. *Lucas*, 281 U.S. at 114-15.

Assignments for *consideration* spring from "an urge to enjoy capital gains [tax] treatment on what would otherwise be ordinary income." D. POSIN, *supra* note 57, at 267. A major case in this area is *Hort v. Commissioner*, 313 U.S. 28 (1941), in which a lessor received a lump sum payment from the lessee in exchange for the cancellation of the lease. *Id.* at 29. While the payment to the lessor was \$140,000, the lessor reported a loss of income on the theory that the \$140,000 was still less than he would have received as fair rent. *Id.* The Supreme Court held that the \$140,000 was ordinary income since it was a substitute for rent. *Id.* at 31. For a discussion of the direction the Court has taken since *Hort*, see D. POSIN, *supra* note 57, at 270-73.

63. Eustice, *Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case*, 20 TAX. L. REV. 1, 22 (1964). In his article, Professor Eustice discusses court decisions involving the transfer of various contract rights, whether by sale

asserted against transferors of copyrighted property. Assignment of income principles are not used in the patent context because a patent transfer in exchange for contingent payments (i.e., payments based on future use or productivity) is specifically deemed to be a "sale" under I.R.C. section 1235.⁶⁴ However, Revenue Ruling 60-226 states that due to the similarities between copyrights and patents, a copyright transfer of exclusive rights in exchange for royalty payments is also to be treated as a sale.⁶⁵ In the case of a patent, the item transferred will amount to a future income right only if substantial rights are retained by its creator.⁶⁶

A transfer of know-how may be considered a transfer of a property right. Know-how is unpatented technical knowledge or information.⁶⁷ The Service, in Revenue Ruling 64-56, adopted a

or by cancellation, where courts have tested capital gain status under assignment of income principles rather than resorting to other theories such as lack of "sale." *Id.* Under assignment of income principles, the courts have issued conflicting decisions concerning capital asset status of contract cancellation and sales. *Id.* at 23; *see, e.g.*, *General Guaranty Mortgage Co. v. Tomlinson*, 335 F.2d 518 (5th Cir. 1964) (part capital gain, part ordinary income); *Hyatt v. Commissioner*, 325 F.2d 715 (5th Cir. 1963) (ordinary income), *cert. denied*, 379 U.S. 832 (1964); *United States v. Dresser Indus.*, 324 F.2d 56 (5th Cir. 1963) (capital gain).

64. *See* I.R.C. § 1235(a)(2) (Supp. III 1985). For the text of section 1235, *see supra* note 6.

65. Rev. Rul. 60-226, 1960-1 C.B. 26. In Revenue Ruling 60-226, the Service held "that the consideration received by a proprietor of a copyright for a grant transferring the exclusive right to exploit the copyrighted work . . . throughout the life of the copyright shall be treated as proceeds from a sale of property. . . ." *Id.* at 27. The Service stated that this treatment should be given "regardless of whether the consideration received is measured by a percentage of the receipts from the sale, performance, exhibition, or publication of the copyrighted work," or by the number of copies sold or performances given of the copyrighted work. *Id.*

Revenue Ruling 60-226 modified Revenue Ruling 54-409 which had denied treatment as a sale of property to a copyright where the transfer of the exclusive right to exploit is measured by the publication, use, or sale of the copyrighted work. *Id.* (citing Rev. Rul. 54-409, 1954-2 C.B. 174).

Revenue Ruling 60-226 adopted a contrary position because it viewed property rights of patents and copyrights as similar in substance, and, therefore, subject to the same tax treatment. Rev. Rul. 60-226 at 27. The Service, in reaching its decision, however, stated that "whether a copyright is a capital asset within the meaning of section 1221 of the Code and when the provisions of section 1302 of the Code with respect to copyrights would apply are separate and distinct questions which are not considered in this ruling." *Id.*

66. *See* I.R.C. § 1235(a) (Supp. III 1985). For the full text of section 1235(a), *see supra* note 6.

67. *See* *Hooker Chems. & Plastics Corp. v. United States*, 591 F.2d 652, 665 (Ct. Cl. 1979); *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965); *Heil Co. v. Commissioner*, 38 T.C. 989 (1962); Rev. Rul. 64-56, 1964-1 C.B. 133; Eustice, *supra* note 63, at 31; Morreale, *supra* note 46, at 564.

test to determine whether know-how that is transferred is a property right or a right to future income. The test focuses on resemblance to a patentable invention, although patentability is not necessary.⁶⁸ The United States Court of Claims has specifically held that a secret process is property.⁶⁹

In the copyright area, when an artist transfers a copyright, the Service could easily characterize the transfer as a transfer of a right to receive future income and, therefore, under assignment of income principles, tax the gain to the transferor as ordinary

68. Rev. Rul. 64-56, 1964-1 C.B. 133, 134. Revenue Ruling 64-56 addressed the issue of whether technical "know-how" constitutes property which can be transferred in exchange for stock or securities under section 351 of the Code, without recognition of gain or loss. *Id.* at 133. Section 351 of the Code states that, generally, "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and [if] immediately after the exchange such person or persons are in control . . . of the corporation." I.R.C. § 351(a) (1982).

The issue regarding the resulting tax consequences arose when a domestic manufacturer agreed to assist a newly organized foreign corporation in making and selling abroad the same kind of product that it made. Rev. Rul. 64-56 at 133. The transferor (the manufacturer) typically granted the transferee (the newly organized corporation) the right to use manufacturing processes which, as patents, are the exclusive rights of the transferor and furnish ongoing technical assistance in the operation of the plant. *Id.* The transferor's consideration in part typically contained what is commonly called "know-how" in exchange for substantially all the stock of the transferee. *Id.*

The ruling stated that under section 351, property would include "secret processes and formulas . . . in the general nature of patentable invention. . . ." *Id.* at 134. The Service also stated that "[w]here the transferor agrees to perform services in connection with a transfer of property, tax free treatment will be accorded if the services are merely ancillary and subsidiary to the property transfer." *Id.* This determination is a question of fact. *Id.*; see also *United States Mineral Prods. Co. v. Commissioner*, 52 T.C. 177, 196-98 (1969); *Heil Co. v. Commissioner*, 38 T.C. 989, 1003 (1962).

69. *E.I. Du Pont De Nemours & Co. v. United States*, 288 F.2d 904 (Ct. Cl. 1961). In *Du Pont*, the Du Pont company developed a chemical process which was at first thought to be non-patentable and was kept a secret. *Id.* at 909. Du Pont sold the blueprints of the process to another company in exchange for \$225,000. *Id.* at 910. The buyer agreed to keep the process secret for five years, but Du Pont retained the right to disclose the process to others. *Id.* Du Pont claimed that the sale of the process was property subject to capital gains treatment. *Id.*

The court, however, denied capital gains treatment to the transfer, pointing out that in order for a secret process to be treated as a sale of property, the owner of the trade secret must transfer not only the right to use the secret, but also the right to prevent unauthorized disclosure. *Id.* at 912. Du Pont had failed to meet this requirement because it retained the right to make future disclosures of the process. *Id.* The court required prevention of future disclosures because a trade secret derives its value from the fact of its secrecy. *Id.* at 911. No disposition of a trade secret would be complete without some transfer of the right to prevent unauthorized disclosure. *Id.*; see also *Hooker Chems. & Plastic Corp. v. United States*, 591 F.2d 652, 665 (Ct. Cl. 1979) (sale of patent rights and know-how held sale of property entitled to capital gains treatment).

income. Artists, therefore, are often forced to rely on a transfer of contract rights argument in an attempt to achieve capital gains treatment for their exchanges.

There are several cases holding that an artist's transfer of contract rights to receive future income does constitute a transfer of a property right. In *Lewis v. Rothensies*,⁷⁰ for example, the United States District Court for the Eastern District of Pennsylvania in 1944 stated that "[w]hen an author writes a book the literary ideas embodied in the manuscript are property."⁷¹ When the author "sells the manuscript in exchange for royalties his interest in the contract by which the royalties are paid is property."⁷² The court, therefore, implicitly recognized a contract right as property.

Five years later, in *Wodehouse v. Commissioner*,⁷³ the United States Court of Appeals for the Second Circuit adopted a similar approach, holding that an assignment of an interest in an author's unpublished manuscript would be effective to shift the tax burden to the taxpayer's donee.⁷⁴ In *Wodehouse*, the gift was made before the property was producing any income.⁷⁵

Then, in 1956, the United States Court of Appeals for the

70. *Lewis v. Rothensies*, 61 F. Supp. 862 (E.D. Pa. 1944), *aff'd per curiam*, 150 F.2d 959 (3d Cir. 1945).

71. 61 F. Supp. at 862. In *Lewis*, the taxpayer, an author under contract with his publisher to receive royalties, assigned the contracts to his children. *Id.* at 862. The court held that the royalties were taxable to the taxpayer, regardless of whether the royalties were income derived from personal services or from income-producing property. *Id.* at 863. In *dicta*, however, the court stated that the royalties were income from income-producing property, because royalties are derived from the *sale* of a written work. *Id.* at 862.

72. *Id.* When he sells the book, the author's interest in the contract by which royalties are paid is his property. *Id.* The court noted that the book was property even though it came into being by the taxpayer's own personal services. *Id.*

73. *Wodehouse v. Commissioner*, 177 F.2d 881 (2d Cir. 1949).

74. *Id.* at 884-85. In *Wodehouse*, the taxpayer executed an assignment to his wife of an undivided one-half interest in an unpublished story. *Id.* at 882. The one-half interest was incorporated in the contracts regarding the sale of any rights to the story. *Id.* The story was later sold and royalties were received by the taxpayer and his wife (half each respectively). *Id.* The Tax Court, however, found that the assignment of the one-half interest was not a bona fide gift, and consequently charged all the royalties to the gross income of the taxpayer. The Second Circuit reversed the decision and remanded, stating that the Tax Court had failed to show sufficient evidence that the transfer was not a bona fide gift. *Id.* at 884-85.

75. *Id.* at 882. The Second Circuit noted that the taxpayer had "no contract right to [the] royalties when he made the gift." *Id.* at 881. He assigned property (the one-half interest in the story) to his wife and the income which the wife received was paid under a contract with respect to her half-interest in the manuscript. *Id.*

First Circuit held in *Commissioner v. Reece*⁷⁶ that a royalty contract itself was income-producing property which may be transferred to shift income. In *Reece*, the taxpayer assigned his invention to a corporation in exchange for a contract to receive royalties.⁷⁷ A few years later, he made an irrevocable assignment of the contract to his wife and paid the gift tax.⁷⁸ The corporation assented to the transfer and paid the royalties to the wife.⁷⁹ Reasoning that this transaction was a novation and that the assignment was a valid transfer of property rights as opposed to a mere transfer of rights to receive future income, the court found that the royalty payments were taxable to the wife.⁸⁰ The court considered Reece's complete divestiture of control over the item transferred as an important factor in deciding that the transferred contract right amounted to property.⁸¹

76. *Commissioner v. Reece*, 233 F.2d 30 (1st Cir. 1956).

77. *Id.* at 30-31.

78. *Id.* at 31. The assignment provided as follows:

Know All Men By These Presents:

That I, Franklin A. Reece, of Chestnut Hill, Massachusetts, in consideration of love and affection, hereby assign and transfer to my wife, Marie Teresa Reece, her executors, administrators and assigns, my royalty contract with the Universal Winding Company as set forth in its letter to me dated February 5, 1929, covering my invention, together with all my right, title and interest in and to payments now due or hereafter to become payable to me by said Company thereunder; the said contract to be held by my said wife for her own use and behoof as fully and entirely as the same would have been held by me had this assignment not been made.

Executed this 26 day of December, 1935.

(s) Franklin A. Reece (S)

In the presence of:

(s) J.W. Nichols

Universal Winding Company hereby consents and agrees to the above assignments and acknowledges receipt of notice thereof, this * * day of December, 1935.

Universal Winding Company

By (s) Robert A. Leeson

President

Id.

79. *Id.* The court found that these payments were made solely for the wife's use and benefit and were not subject to any control by the taxpayer. *Id.*

80. *Id.* at 31, 35. The court noted that upon the sale of his patent rights, the taxpayer had received "a new kind of property interest, a chose in action, a contract right No doubt this contract right . . . was property of the taxpayer" *Id.* at 33.

81. *Id.* at 33-35; see also Shine, *Some Tax Problems of Authors and Artists*, 13 TAX L. REV. 439 (1958). The Shine article discusses whether an assignment of an interest in a royalty contract itself, rather than the assignment of the right to receive royalties, would shift the burden to the assignee. *Id.* at 454. After analyzing the *Reece* case, Mr. Shine suggests that assignment of income rules where income is derived from salary, wages, or compensation for personal services do

In reviewing these cases, one must remember that the courts dealt with the issue of the transfer of a property right in the context of the shifting of income. Once the property is sold by the donee, however, the legislators of I.R.C. section 1221 have assured that a gift of copyrighted property will produce ordinary income for the donee.⁸² There is a congressional assumption that the artist realizes no income on the donative transfer and that the income realized on the donee's subsequent transfer will be taxed to the donee.⁸³ The Service, in Revenue Ruling 54-599, has stated that the income can be shifted to the donee provided there is a complete divestiture of control over the property interest transferred.⁸⁴

not apply to the assignment of a royalty contract which is a property right itself. *Id.* at 456 (citing *Reece*, 233 F.2d 30 (1st Cir. 1956)). The donor could, through a gift, divest himself of all control over the property right, thereby shifting all incidents of ownership to the donee. Shine, *supra*, at 456.

82. See I.R.C. § 1221(3)(C) (1982). For the full text of section 1221(3)(C), see *supra* note 28 and accompanying text.

83. See, e.g., *Farrier v. Commissioner*, 15 T.C. 277 (1950) (donor did not realize taxable gain income on gift of cattle to donee); S. REP. NO. 2375, 81st Cong., 2d Sess. 43-44, reprinted in 1950 U.S. CODE CONG. & AD. NEWS, 3053, 3097; see also Beghe, *The Artist, the Art Market and the Income Tax*, 29 TAX L. REV. 491, 505 (1974). Mr. Beghe discusses the treatment of a gift of copyrighted property by the use of the following example. *Id.* at 504. An artist paints a painting at a production cost of \$100. Upon completion, the painting has a value of \$1,000. *Id.* Instead of selling it, he holds it until the value has reached \$10,000. *Id.* He either dies while still holding the piece, gives it to a family member or donates it to a museum. *Id.* The transferee later sells the painting for \$100,000. *Id.* at 505.

The article suggests that under § 1221(3)(C), the sale of the artist's work will be ordinary income. *Id.* This result reflects the congressional assumption "that the artist realizes no income on the donative transfer and that the income realized on the donee's subsequent sale of the work will be attributed to the donee rather than the donor." *Id.* (footnote omitted).

Mr. Beghe finds justification for this congressional assumption in light of the commissioner's concession after the *Wodehouse* case, "that a gift of the exclusive rights to a copyright in one medium would shift the income on realization to the donee, provided there was a complete divestiture of control over the property interest transferred." *Id.* Also, later cases held "that where the property was the product of the donor's personal efforts (rather than personal services rendered to another) the creator would not be taxed on the income realized when the donee subsequently sold or otherwise disposed of an interest in the property." *Id.* See, e.g., *Commissioner v. Reece*, 233 F.2d 30 (1st Cir. 1956).

Mr. Beghe states that the law recognizing an all or nothing approach by requiring that the gross income on the sale or disposition of a gift be taxed in its entirety to either the donor or the donee is an obstacle to arriving at a theoretically satisfying conclusion. Beghe, *supra*, at 506. The article suggests that there should be an apportionment between the production of income and the sale income. *Id.* For a further discussion of *Wodehouse*, see *supra* notes 73-75 and accompanying text. For a further discussion of *Reece*, see *supra* notes 76-81 and accompanying text.

84. Rev. Rul. 54-599, 1954-2 C.B. 52. Revenue Ruling 54-599 was issued

Furthermore, a recent Private Ruling⁸⁵ reaffirms the position of the Service on the issue of an assignment of a royalty contract as a valid assignment of property rights that is effective to shift income. In that Ruling, the Service considered the transfer in trust of a royalty contract with respect to a book that has already been written. The Service reasoned that the literary ideas embodied in the manuscript were property. When the author sells the book to a publisher, he receives in exchange a contract right to receive royalties, and that contract right is itself income-producing property. Here, the entire tree (property right) was transferred with the result that the assignment of income doctrine did not make the author taxable on the royalties which would be paid in the future to the trust.⁸⁶

The United States Court of Appeals for the Second Circuit, in *Commissioner v. Ferrer*,⁸⁷ addressed the issue of whether a property right or an income right is transferred in the context of copy-

in response to Revenue Ruling 54-409 which held that copyrights are divided into separate properties and that a grant of the exclusive right to exploit a copyrighted work in a specific medium, such as radio, television, movies, or the stage, throughout the life of the copyright, transfers a property right. Rev. Rul. 54-409, 1954-2 C.B. 174. Revenue Ruling 54-599 held that where a taxpayer transfers by gift all his rights in the dramatization of his novel for its production in a specific medium, he is not liable for federal income tax with respect to any income derived from his former interest in the right to dramatization. Rev. Rul. 54-599, 1954-2 C.B. 52. Rather, any income from such dramatization rights would be taxable to the donee. *Id.* For a further discussion of Revenue Ruling 54-409, see *infra* note 122.

85. Private Ruling 8217037 (Internal Revenue Service Jan. 27, 1982) (available on Lexis, Fed. Tax Library, P.R. file).

86. The Private Ruling was in response to a letter from a taxpayer who wrote a non-fiction book and entered into a royalty contract with a publisher for the payment of a royalty based on sales of the book. The taxpayer gave the publisher the exclusive right to print, publish and sell the book. The publisher agreed to pay royalties on the copies sold.

The taxpayer then transferred a royalty contract into two separate trusts created for the benefit of two minor children. The specific issue posed to the Internal Revenue Service was whether the royalties paid under the royalty contract after the transfer would be taxable to the trust and/or their respective beneficiaries.

The Service held that the transfer was a gift of income-producing property. It adopted the reasoning of *Lewis v. Rothensies*, 61 F. Supp. 862 (E.D. Pa. 1944), *aff'd per curiam*, 150 F.2d 959 (3d Cir. 1945), which found that the literary ideas embodied in a manuscript were property. When the author sells the book in exchange for royalties, the royalties are derived from income-producing property. For a discussion of *Lewis*, see *supra* notes 70-72 and accompanying text. Therefore, the transfer of the royalty contract interests to the trusts were a transfer of income-producing property. Any royalties received after the transfer of the contract right to the trust would be taxed to the trust. See also Cutrow, *Estate Planning for the Artist*, in REPRESENTING ARTISTS, COLLECTORS AND DEALERS 347 (1983).

87. *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962).

righted property. Because Ferrer is a performing artist, this case is of special significance to the topic of copyrights.

At common law, a performing artist generally has a copyright in his performance if the performance is not fixed (i.e., not filmed or recorded).⁸⁸ Once fixed, his copyright in his performance is protected by federal statute.⁸⁹ The Treasury Regulations of the Internal Revenue Service state that the term "similar property" in I.R.C. section 1221(3), which denies capital treatment to copyrighted property, includes a theatrical production and "any other property eligible for copyright protection (whether under statute or common law)."⁹⁰ Further, as a performing artist, if payments received are for future services, then the amount received in the transfer will be ordinary income either under I.R.C. section 61 as compensation, or under the assignment of income doctrine. Finally, if the item transferred is a property right entitled to copyright protection and held by its creator, then I.R.C. section 1221(3) will deny it capital gain treatment.

88. See 1 M. B. NIMMER, *supra* note 2, § 2.02 (1986). Unpublished works are automatically protected by state law. This protection begins at the moment of creation and terminates upon publication, when the common law copyright is lost. *Id.* The common law protection covers any work which is not fixed in a tangible form of expression such as choreography that has never been filmed or notated, an extemporaneous speech, original works of authorship communicated solely through conversations or live broadcasts, and dramatic sketches or musical compositions improvised or developed from memory without being recorded or written down. *Id.*

89. The Federal statute that protects copyrights in such performances is 17 U.S.C. § 102 (1982). Section 102 provides:

(a) Copyright protection subsists, in accordance with this title, in original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. Works of authorship include the following categories:

- (1) literary works;
- (2) musical works, including any accompanying words;
- (3) dramatic works, including any accompanying music;
- (4) pantomimes and choreographic works;
- (5) pictorial, graphic, and sculptural works;
- (6) motion pictures and other audiovisual works; and
- (7) sound recordings.

(b) In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work.

Id.

90. Treas. Reg. § 1.1221-1(c)(1), T.D. 7369, 1975-2 C.B. 335, 336. For a discussion of Treas. Reg. § 1.1221-1(c)(1), see *supra* note 31 and accompanying text.

In *Commissioner v. Ferrer*,⁹¹ Jose Ferrer showed that he stood in a different relationship to the copyrighted property transferred because he himself did not create it.⁹² *Ferrer* is significant because the court was willing to splinter the rights transferred, finding that two were property rights and the third was for compensation.⁹³ The pertinent facts in the *Ferrer* decision are as follows: Jose Ferrer acquired the exclusive dramatic production rights in a play based on a novel written by LaMure.⁹⁴ The author reserved full equitable and legal title to the copyrighted play,⁹⁵ although Ferrer had the power to block the author's transfer of retained film rights.⁹⁶ Ferrer was granted a lease of the exclusive theatrical production rights.⁹⁷ If the author sold the play with Ferrer's consent, Ferrer would get a contingent royalty interest in the consideration received.⁹⁸

Before the play was produced, a film company bought the film rights from the author.⁹⁹ The film company had Ferrer sign a release of his rights and also hired him to star in the film.¹⁰⁰ Ferrer was to receive a stipulated salary for his acting services.¹⁰¹ For the release of his rights, he received a seventeen percent interest in the net profits of the film.¹⁰² The amount that Ferrer received

91. *Ferrer*, 304 F.2d 125 (2d Cir. 1962).

92. *Id.* at 132.

93. *Ferrer*, 304 F.2d at 134-35. For a discussion of the significance of the court's holding, see *infra* notes 104-06 and accompanying text.

94. *Ferrer*, 304 F.2d at 126-27. The contract provided that LaMure "leased" to Ferrer "the sole and exclusive right" to produce and present the play on stage in the United States and Canada. *Id.* at 127.

95. *Id.* The contract, however, excepted from LaMure's retained rights the right to produce the play. *Id.* In addition, the Motion Picture Negotiator was given the power to dispose of the motion picture rights but only upon the written consent of both LaMure and Ferrer. *Id.*

96. *Id.* This provision protected Ferrer from dilution of the value of his right to produce the play due to its premature exposure as a motion picture.

97. *Id.*

98. *Id.*

99. *Id.* at 128. LaMure sold the rights on the strength of Ferrer's assurances that he would be willing to abandon the theatrical production in exchange for compensation upon successful film production. *Id.*

100. *Id.* LaMure's lawyer prepared the release. *Id.* Ferrer signed the agreement but advised his attorney not to deliver it until the closing of his contract with the motion picture production company. *Id.* This contract was executed on May 7, 1952 and the release was subsequently delivered on May 14. *Id.*

101. *Id.* Ferrer was to receive \$50,000 for the first twelve weeks of his performance plus \$10,416.66 for each additional week payable out of net receipts. *Id.* Ferrer was also to receive a stipulated percentage of net profits. *Id.* at 128-29.

102. *Id.*

for the release of his rights in the film was at issue.¹⁰³ The rights transferred by Ferrer to the film company were contract rights. Thus, Ferrer was able to get capital gain treatment for part of his interest.

Despite the *Reece* and *Wodehouse* cases, there has been a hostile judicial climate towards allowing capital gain treatment for the disposition of contract rights. The courts have declared that such rights are not property in the tax sense; that the consideration received is merely a lump sum for future ordinary income; or that the property is acquired to serve a business purpose.¹⁰⁴ However, because the court in *Ferrer* was willing to fragment the interest which Ferrer had under the contract, Ferrer was able to get capital gain treatment for part of his interest. The exclusive theatrical production rights held by Ferrer were likened to a

103. *Id.* at 128-29.

104. *See, e.g.,* Commissioner v. Gillette Motor Transp. Co., 364 U.S. 130 (1960). In *Gillette*, the owner of a trucking company received compensation from the government which had assumed control of his facilities during World War II. *Id.* at 131. The Supreme Court held that this compensation constituted ordinary income and not a capital gain resulting from an involuntary conversion of his capital assets. *Id.* at 135-36. The Court based its conclusion on its opinion that what the government had "taken" was the right of the owner to determine the use to which his facilities could be put and such a right is not a capital asset. *Id.* at 135. The Court held that "the right to use is . . . simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent." *Id.*

In Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958), a company assigned an oil payment right to its president in consideration for the cancellation of a \$600,000 debt owed by the firm to the president. *Id.* at 262. The corporation reported the oil payment assignment as a sale of property producing a \$600,000 profit, taxable as a long-term capital gain. *Id.* The Court ruled that there was no conversion of a capital asset but merely a lump sum "substitute for what would otherwise be received at a future time as ordinary income." *Id.* at 265.

In Corn Prod. Refining Co. v. Commissioner, 350 U.S. 46 (1955), the Supreme Court held that commodities futures, which are contracts "to purchase some fixed amount of a commodity at a future date for a fixed price," were not separate from Corn Products' manufacturing process but actually vital to it and were not "property" entitled to capital gain treatment. *Id.* at 47 n.1, 50. *See also* Eustice, *supra* note 63, at 3. Professor Eustice points out that the hostile treatment to the disposition of contract rights is difficult to explain especially where other groups, such as executives with stock options, farmers, inventors and live-stock breeders, receive more favorable treatment under existing capital gain rules. *Id.*

Professor Eustice asserts that a taxpayer can prevail on the capital gain question if he or she can show one or more of the following factors: (1) the rights are incidental to real or personal property; (2) the transfer is made to a third person by way of assignment rather than by cancellation of rights; (3) the transaction relates to a specific statutory provision; (4) the taxpayer has made a substantial capital investment in his contract rights; and (5) the rights represent an interest that can appreciate in value over a period of years, rather than a right to receive a fixed amount of ordinary income. *Id.* at 4.

leasehold interest in real property. Ferrer's power to prevent the author from transferring his retained film rights was found by the court to be an encumbrance which clouded the author's title to his property. The third right was the contingent royalty interest Ferrer would get if the author sold his copyrighted work. The contract stipulated that the author held all title to the work. As such, Ferrer's only right was to share in the future proceeds of property owned by another. Therefore, the sale of this interest was found to produce ordinary income.¹⁰⁵

The *Ferrer* court looked to the existence of an equitable interest or estate in specific property to determine whether the interest transferred was a property right. At the same time, the court held that the right to share in the profit of another's property was not a capital asset.¹⁰⁶

In *Nat Holt v. Commissioner*,¹⁰⁷ the Tax Court similarly held that certain performers and entertainers could receive capital gain treatment for a transfer of contract rights, but to do so, they must transfer rights in, or title to, a tangible asset such as a story or radio or television show. In *Holt*, Nat Holt entered into agreements with Paramount Pictures Corporation to produce eleven motion pictures for Paramount.¹⁰⁸ Holt was to receive a fixed producer's fee of \$15,000 or \$20,000 for each film produced and a 25% participatory interest in the excess gross receipts of the picture.¹⁰⁹ After nine of the eleven films were produced, Holt

105. *Ferrer*, 304 F.2d at 133-34. Professor Eustice agreed with the court, stating that Ferrer's right to a contingent royalty interest in any consideration earned by the author from his sale of the retained film rights was taxable as ordinary income rather than capital gain because Ferrer did not obtain any property interest, legal or equitable, in the film rights. Eustice, *supra* note 63, at 9. Rather, the contract specified that the entire interest was retained by the author. *Id.* Ferrer's only interest was his right to share in the proceeds of the property owned by LaMure, and was, therefore, an ordinary income right. *Id.*

Professor Eustice further suggests that if the play had been produced and LaMure had sold the movie rights, Ferrer's resulting royalties would have been ordinary income. *Id.* Professor Eustice points to the court's recognition that the contingent royalty rights were not enhanced by the fact that the contingency never occurred (i.e., the play was never produced). *Id.* Rather, what Ferrer received to cancel these rights was merely a substitute for future ordinary income. *Id.*

106. *Ferrer*, 304 F.2d at 133.

107. *Holt v. Commissioner*, 35 T.C. 588 (1961), *aff'd*, 303 F.2d 687 (9th Cir. 1962).

108. 35 T.C. at 589-90, 593-94.

109. *Id.* at 591, 594. The fee for the first two pictures was to be paid as follows: \$5,000 upon approval of the story material, \$5,000 upon commencement of the photography and \$5,000 upon completion and delivery of the picture. *Id.* at 591.

and Paramount entered into an agreement terminating the production of any further pictures, wherein Paramount paid \$153,000 to Holt and Holt released Paramount from all obligations with respect to the remaining two films.¹¹⁰

At approximately the same time as the production agreements were terminated, Holt bought two unproduced picture stories from Paramount for \$500, one of which was later sold for \$15,000.¹¹¹

The Tax Court addressed the issues of whether the \$153,000 and \$15,000 payments received by Holt were ordinary income or capital gain.¹¹² The court held that the \$153,000 payment was ordinary income because it was a substitute for future income which Holt would have received if he had produced the two remaining pictures.¹¹³ The court found that the \$15,000 payment for the sale of the story was capital gain, implying that a story was a capital gain asset.¹¹⁴

Sale or Exchange Issue

Another impediment to capital gain treatment under section 1222 of the Code is that a taxpayer must "sell or exchange" a capital asset in order to be able to realize long-term capital gain.¹¹⁵ Therefore, once the taxpayer shows that the rights he has transferred are property rights, he must then also be able to show that he has actually given up control of those rights.¹¹⁶ If the taxpayer fails to make this showing, the court can find that the assignment of income doctrine applies, and deny capital gain treatment to the transaction.¹¹⁷

In the case of a transfer involving a patent, section 1235 spe-

110. *Id.* at 595-96. \$7,625.00 was to be paid to Holt on or before December 31, 1953; \$114,875.00 was to be paid on January 11, 1954; and \$30,500.00 was to be paid on January 10, 1955. *Id.* at 595.

111. *Id.* at 597. These two stories were the works that Holt had originally agreed to produce for Paramount but he later obtained a release. *Id.*

112. *Id.* at 598, 600.

113. *Id.* at 598-99. The court noted that the amount received for the cancellation of the right to produce the two films was not a return of capital. *Id.* at 599. The nature of the property right relinquished did not turn the receipt of mere future income into the sale of a capital asset. *Id.*

114. *Id.* at 601.

115. I.R.C. § 1222(3) (Supp. III 1985). For the text of section 1222(3), see *supra* note 4.

116. See, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930). For a discussion of the facts in *Lucas*, see *supra* note 62.

117. For a further discussion of the doctrine of assignment of income, see *supra* note 62.

cifically states that the taxpayer need only show that he has parted with all "substantial rights" to the patent in order to have the transaction deemed a sale of a capital asset.¹¹⁸ A copyright, on the other hand, has traditionally been viewed by courts as a bundle of separate but indivisible rights.¹¹⁹ A transfer of less than all the rights in the copyrighted property was not a sale, but rather was viewed as a license.¹²⁰ Often, a copyright creator would transfer his work but retain the copyright itself (i.e., the right to make copies remained with the artist). The purchaser of the copyrighted property could not then realize capital gain upon its subsequent transfer because he could not transfer all of the rights in the property.¹²¹ Then, in 1950, the Service issued Revenue Ruling 54-409 which stated that a copyright could be divisible for tax purposes provided that the consideration received for a transfer of less than the whole bundle of rights is a fixed sum, is not based on a percentage of future sales, and is not payable over a period coterminous with the grantee's use of the work.¹²²

In 1960, in Revenue Ruling 60-226, the Service modified

118. I.R.C. § 1235(a) (Supp. III 1985). For the text of section 1235, see *supra* note 6.

119. See, e.g., *Cory v. Commissioner*, 230 F.2d 941 (2d Cir. 1956), *cert. denied*, 352 U.S. 828 (1956), in which the Second Circuit upheld the finding of the Tax Court that only a part of the "bundle of rights" that constitute a copyright was transferred. See also *Shine*, *supra* note 81, at 442.

120. *Cory v. Commissioner*, 230 F.2d 941, 943 (2d Cir. 1956) (when only part of "bundle of rights" constituting copyright is transferred, transfer is grant of license rather than sale of property), *cert. denied*, 352 U.S. 828 (1956); see also *Shine*, *supra* note 81, at 442.

121. See *Shine*, *supra* note 81, at 443. For a general discussion of the *Shine* article, see *supra* note 81.

122. Rev. Rul. 54-409, 1954-2 C.B. 174. Prior to Revenue Ruling 54-409, the Service maintained the position that a copyright was not divisible into separate properties and that a grant of less than all rights conferred by a copyright must be a license (the consideration received being rental or royalty income) and not a sale. *Id.* at 174-75 (citing I.T. 2735, C.B. XII-2, 131 (1933)). The Service changed its position in light of the marketplace in which copyrights were bought and sold. *Id.* at 175. The Service noted that what constitutes a separable and defined piece of property in the marketplace was relevant in determining whether transfers of copyrights were a sale of property or a rental. *Id.* The Service stated that even though the grantee of less than all the rights conferred by a copyright is a "licensee," this had nothing to do with the question of what rights in the copyright do or do not constitute separable property. *Id.* (citing *Independent Wireless Co. v. Radio Corp.*, 269 U.S. 459 (1926)). Rather, the Service recognized that a grant of less than all the rights in a copyright can be a sale of property where the exclusive right to exploit the copyrighted work is given in a particular medium. *Id.* The Service reasoned that the grant of the exclusive right to exploit a copyrighted work in a particular medium may itself be copyrighted as if it were a new work. *Id.* Thus, the grant conveyed a property right. *Id.* (citing *L. C. Page & Co. v. Fox Film Corp.*, 83 F.2d 196 (2d Cir. 1936)).

Revenue Ruling 54-409 by stating “that assignments of copyrights will not be denied treatment as sales solely because of the form which the purchase price takes.”¹²³ The Revenue Ruling held that

the consideration received by a proprietor of a copyright for a grant transferring the exclusive right to exploit the copyrighted work . . . throughout the life of the copyright shall be treated as proceeds from the sale of property, regardless of whether the consideration received is measured by a percentage of the receipts from the sale, performance, exhibition or publication of the copyrighted work, or is measured by the number of copies sold. . . .¹²⁴

Significantly, the Service stated that its ruling was based on the similarities between copyrights and patents, and the explicit mandate of the Code that patents be given sale treatment whether payments are contingent or periodic.¹²⁵

Furthermore, in 1983, the Service stated in General Counsel Memo 39252¹²⁶ that an author who did not grant worldwide rights in her novels to a publisher was not precluded from treating the transfers as sales.¹²⁷ It was sufficient that exclusive rights were granted for each of the three countries covered by the contracts between the author and the publisher.¹²⁸ The memo rea-

123. Rev. Rul. 60-226, 1960-1 C.B. 26, 27.

124. *Id.* at 26. For a further discussion of Revenue Ruling 60-226, see *supra* note 64 and accompanying text and *infra* note 148 and accompanying text.

125. Rev. Rul. 60-226, 1960-1 C.B. 26, 27.

126. G.C.M. 39252, 24 TAX NOTES 362 (1984).

127. *Id.* at 363.

128. *Id.* In G.C.M. 39252, “A,” an author, granted to the publisher “the exclusive right to print, publish, and license publication of her novel . . . in the United States, Canada and the Philippines.” *Id.* at 362. The publisher paid \$2,500 on execution of the contract and an additional \$2,500 on delivery of the manuscript. *Id.* The money was treated as an advance on royalty payments but was not repayable. *Id.* Royalties were “based on the number of books sold and the type of edition.” *Id.* “A” was the owner of the copyright on the novel, and the contract did not transfer all of the rights arising under the copyright, only those enumerated. *Id.* “A” retained the right to terminate the contract if the publisher failed to keep the book in print or became bankrupt. *Id.*

“A” proposed to transfer all the assets and liabilities of her business as an author to a corporation. *Id.* The transfer would include all of her rights, title, and interest in her copyrighted works, including her contracts with the publisher. *Id.*

The first issue presented was whether “A” “was currently taxable on the fair market value of deferred guaranteed payments and royalties to be received from [the] publisher in exchange for the transfer of the publication rights to the novel she had written.” *Id.* The Service concluded that “the fair market value of the

soned that this was sufficient for patents and is in accord with Revenue Ruling 60-226.¹²⁹

At an earlier date, the Tax Court, in *TeLinde v. Commissioner*,¹³⁰ had held that merely because the consideration received for a transfer of all the rights in a copyrighted property was not a fixed amount, what would otherwise be a sale is not transmuted into a mere license.¹³¹ The taxpayer in *TeLinde* sold his entire interest in a manuscript in exchange for royalty payments based

rights acquired by the author under the contract was not taxable [to "A"] in the year the right to publish the novel was sold to the publisher." *Id.* Payments under the contract were taxable to the author, a cash-basis taxpayer, when received. *Id.* at 363 (citing, e.g., *Oates v. Commissioner*, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953)).

In so holding, the Service noted that "a sale may occur upon the grant of the exclusive right to exploit a copyrighted work in a medium of publication throughout the life of the copyright, regardless of whether the consideration received by the grantor" is based on proceeds from sales of the book or receipts payable over a period of time coterminous with the term of the grant. *Id.* at 362 (citing Rev. Rul. 60-226, 1960-1 C.B. 26). The right of the grantor to terminate the grant upon certain subsequent conditions was not inconsistent with sale treatment. *Id.* (citing Rev. Rul. 58-353, 1958-2 C.B. 408). The Service also relied on Revenue Ruling 75-202, which held that "amounts received by a corporation under a contract by which it conveyed a book copyright in exchange for royalties are income from the sale of the copyright and not copyright royalties. . . ." *Id.* (citing Rev. Rul. 75-202, 1975-1 C.B. 170). For a discussion of Revenue Ruling 60-226, see *supra* note 65 and accompanying text.

The second issue presented was whether the assignment of income principle required that the royalties the corporation received be taxed to "A," the author, rather than to the corporation. *Id.* at 363. The Service held that the payments were taxable to the corporation, noting that "the assignment of income principle has not been applied to cases in which a taxpayer assigns income producing property to his controlled corporation. . . ." *Id.* (citing *Fox v. Commissioner*, 37 B.T.A. 271 (1983), *relying on Blair v. Commissioner*, 300 U.S. 5 (1937)).

129. G.C.M. 39252, 24 TAX NOTES at 362.

130. *TeLinde v. Commissioner*, 18 T.C. 91 (1952).

131. *Id.* at 95. In *TeLinde*, the publisher sold copies of the book the same day as the publisher copyrighted the book. *Id.* at 94. On April 30, 1947, the author received his first royalty check which he claimed as long-term capital gains. *Id.* The I.R.S. challenged this treatment and asserted that the royalties were taxable as ordinary income. *Id.* In the alternative, the I.R.S. argued that even if it was a sale, the amount would be taxable as a short-term capital gain because the asset was held less than six months. *Id.*

The court held that the royalty income was subject to capital gains treatment because the publisher received all of the rights incorporated in the property for the full term of the copyright, leaving no interest in the hands of the transferor. *Id.* at 94-95.

As to the alternative assertion of the I.R.S. concerning the six month holding period, the court held that the time requirement for long-term capital gains treatment was not met because the manuscript was completed by the middle of 1944, but the title did not pass to the publisher until its delivery in August, 1945, a period of more than six months. *Id.* at 95.

upon future sales.¹³² The taxpayer reported the royalty payments from the publisher as long-term capital gains.¹³³ The Service argued that the payments were ordinary income or, alternatively, they should be taxable as short-term capital gain because if the transaction was a sale, the asset had been held less than six months.¹³⁴ Since the author had contracted with the publisher in 1941 and had not written the book until 1944, the contract dealt with property that was not yet in existence and thus did not encompass passage of title.¹³⁵ Since by January, 1945 the author had the completed manuscript in his possession and did not deliver it until August, 1945, more than six months had passed prior to its sale.¹³⁶ To have his transaction adjusted as a sale meant that the author could realize long-term capital gain.

The sale or exchange issue was also raised in the *Ferrer* case.¹³⁷ While the United States Court of Appeals for the Second Circuit held that payments received from the cancellation of some exclusive contract rights were ordinary income due to a lack of sale or exchange,¹³⁸ the Tax Court in *Ferrer v. Commissioner*¹³⁹ reasoned that, since Ferrer was not in the business of dealing in literary property, his contract rights were sufficiently significant and that "cancellation" of those beneficial interests was a sale of capital assets.¹⁴⁰ The Second Circuit examined each of Ferrer's contract rights individually and determined that two "were 'capital assets' and one was not."¹⁴¹

I.R.C. section 1222 requires a capital asset to be held for more than six months in order to realize long-term capital gain on its sale or exchange.¹⁴² The court of appeals in *Ferrer* held that

132. *Id.* at 93.

133. *Id.* at 94.

134. *Id.* The parties were in agreement that the property transferred was a capital asset. *Id.* The difference in opinion centered on the characterization of the transfer. *Id.* The taxpayer contended that the transfer was a sale, while the Commissioner argued that the transfer constituted a mere license. *Id.*

135. *Id.* at 95.

136. *Id.*

137. *Ferrer v. Commissioner*, 35 T.C. 617 (1961), *rev'd*, 304 F.2d 125 (2d Cir. 1962).

138. *Ferrer*, 304 F.2d at 130 (citing, *e.g.*, *Commissioner v. Starr Bros., Inc.*, 204 F.2d 673 (2d Cir. 1953) (cancellation of exclusive distributorship did not constitute sale or exchange of capital asset)).

139. *Ferrer*, 35 T.C. 617 (1961).

140. *Id.* at 625-26. See also Eustice, *supra* note 63, at 7.

141. *Ferrer*, 304 F.2d at 133-34. Payment in exchange for "Ferrer's right to receive 40% of the proceeds" was found to be ordinary income. *Id.*

142. I.R.C. § 1222(3) (Supp. III 1985). For the relevant text of section 1222(3), see *supra* note 4.

Ferrer's rights did not fall within section 1221(3) which provides ordinary asset classification for copyrighted property held by its creator.¹⁴³ Since Ferrer was not the creator of the play,¹⁴⁴ the court recognized that payments received in exchange for exclusive contract rights, which served to terminate those rights, constituted a "sale."¹⁴⁵ Therefore, Ferrer could realize capital gain for those payments under section 1222.

The United States Court of Appeals for the Ninth Circuit, in *Holt*, refused to find a "sale" when the taxpayer argued that cancellation of his contract rights with Paramount was a sale of his partnership interest.¹⁴⁶ Because the court found no sale, the taxpayer realized only ordinary income.¹⁴⁷

Thus the outcome of the issue of whether a sale has occurred has different consequences depending upon the role of the taxpayer. In Revenue Ruling 60-226, the Service referred to the holder of a copyright as the "proprietor" in ruling that royalty payments received in exchange for exclusive copyrights were to be treated as a sale.¹⁴⁸ The Service was careful to note in that ruling that whether a copyright was a capital asset within the meaning of I.R.C. section 1221 was a "separate and distinct question."¹⁴⁹

The Service used the term "proprietor in Revenue Ruling 60-226," as opposed to "creator" or even "holder" which could be confused with "holder" as defined in I.R.C. section 1235.¹⁵⁰ Hence, the possibility that the "proprietor" might be one who has purchased the copyrighted property from its creator was left open. A purchaser would want that classification so that on a subsequent transfer, she could have the transaction deemed a sale in order to realize long-term capital gain.

143. *Ferrer*, 304 F.2d at 132. For the text of section 1221(3), see *supra* note 28.

144. *Ferrer*, 304 F.2d at 126.

145. *Id.* at 132-33. Ferrer "sold" his lease of the play and his negative power to prevent disposition of the motion picture, radio and television rights until after the play was produced. *Id.* For a further discussion of *Ferrer*, see *supra* notes 87-103, 138-39 and accompanying text; *infra* notes 151-53, 265 and accompanying text.

146. *Holt v. Commissioner*, 35 T.C. 588 (1961), *aff'd*, 303 F.2d 687, 691 (9th Cir. 1962).

147. *Id.* For a further discussion of *Holt*, see *supra* notes 107-14 and accompanying text; *infra* note 171 and accompanying text.

148. Rev. Rul. 60-226, 1960-1 C.B. 26, 27.

149. *Id.* For a further discussion of Revenue Ruling 60-226, see *supra* note 64 and accompanying text.

150. For the definition of "holder" in I.R.C. § 1235(b), see *supra* note 6.

The *Ferrer* appellate court also utilized the concept of “proprietor.”¹⁵¹ Because Ferrer stood as a proprietor in relation to his rights, and not as a creator or holder, he was able to convince the court to recognize the transfer of two of his rights as producing long-term capital gain.¹⁵² Ferrer had acquired contract rights to the copyrighted property, which the court analogized to real property law (i.e., that these rights were themselves income-producing property). The court was then able to find a “sale” of those rights. With respect to the contingent royalty right which Ferrer would get if the author sold his property, the *Ferrer* court still found a sale, although the court held that the profit from the sale would be ordinary income because it was the sale of a right to future income of property held by another.¹⁵³

151. *Ferrer*, 304 F.2d 125 (2d Cir. 1962).

152. *Id.* at 133-34.

153. *Id.* at 134. General Counsel Memo 39252 indicates that an author or artist in some circumstances may not want to have the transfer of his copyrighted property characterized as a sale. G.C.M. 39252, 24 TAX NOTES 362, 363 (1984). The Memo addressed the case of a taxpayer who wanted the royalty payments to be received in exchange for a grant of exclusive rights in the copyrighted property to be taxed as deferred compensation. In reaching the conclusion that these payments should be taxed when received, the Service reasoned that although the income received from transfers of assets created by the taxpayer's personal efforts were gains from the sale of property under Revenue Ruling 60-226, these payments could still be considered as earned income for the purposes of deferred compensation. *Id.* at 363. To call the transaction a sale, which Revenue Ruling 60-226 allows even if the payments are contingent as long as exclusive rights are granted, means that the property or rights transferred must be valued. *Id.* at 362. So, the transfer of publication rights constituted a sale.

Under Revenue Ruling 60-31, however, in which an author granted his publisher the exclusive right to print, publish and sell a book he had written, the Service held that an author could contract with his publishers to have an employer-employee relationship. Rev. Rul. 60-31, 1960-1 C.B. 174, 176, 178-79. The agreement provided that the publisher would pay the author specified royalties based on the amount of cash received from the sale of the published work, render semi-annual statements of the sales, and at the time of rendering each statement, make settlement for the amount due. *Id.* at 176. On the same day, another agreement was signed by the parties, agreeing that in consideration of, and notwithstanding any contrary provisions contained in the first contract, the publisher would not pay the taxpayer more than \$100,000 in any one calendar year. *Id.* Under this second contract, sums in excess of \$100,000 which accrued in any one calendar year would be carried over by the publisher into the succeeding accounting periods. Additionally, the publisher was not required to pay interest on any excess sums or to segregate any such sums in any manner. *Id.*

The Revenue Ruling held that this arrangement was not materially different from a contract in which an employee and his employer agree to defer the employee's salary; so long as the amounts deferred are unsecured and not represented by indebtedness, there is no constructive receipt. *Id.* at 175, 177-79. The author was required to include the royalties in gross income only in the taxable years in which they were actually received. *Id.* at 179.

In deciding that the payments would be taxed when received, General

Before proceeding to the next issue, a comment about the plight of the artist or author is necessary. As evidenced by General Counsel Memo 39252, the artist is in a kind of limbo. One of his battles is that the service may argue that his transfer is not a sale.¹⁵⁴ In another, he must fight that his transfer is in fact a sale and, therefore, not earned income.¹⁵⁵ Furthermore, he (as well as

Counsel Memo 39252 relied on Revenue Ruling 60-31 and also cited *Tobey v. Commissioner*, in which the court held that the income from the sale of some paintings was earned income for the purpose of I.R.C. section 911. G.C.M. 39252, 24 TAX NOTES at 363 (citing *Tobey v. Commissioner*, 60 T.C. 227 (1973)).

The Tax Court in *Tobey* focused on the distinction between income derived from the taxpayer's personal efforts and income that represents a return of capital. *Tobey v. Commissioner*, 60 T.C. 227 (1973). In so doing, the court rejected two earlier cases which had used the product test to determine whether earned income existed. *Id.* at 232 (citing *E. Phillips Oppenheim v. Commissioner*, 31 B.T.A. 563 (1934); *Frank L. Kluckhohn v. Commissioner*, 18 T.C. 892 (1952)).

The product test looked to the distinction as to whether there was a prior contract or order for the product. Note, *Robida and Tobey: The New Test for Section 911 Earned Income*, 27 TAX LAW 492, 495 (1973). If a contract existed whereby the author had contracted or was employed to write a book, then the payments, either in lump sum or royalties, were for personal services actually rendered and, therefore, came within the term "earned income." If, on the other hand, the product was in existence at the time the contract was agreed upon, then the payments were for the sale or use of the property. Therefore, they were not within the term "earned income." *Id.* (citing G.C.M. 236, VI-2 (C.B. 27 (1927))). This General Counsel Memo was superceded by Revenue Ruling 71-315, 1971-2 C.B. 217, which restated the Service's position.

The *Tobey* court clearly rejected the earlier distinction which was based on the terms of the contract that the taxpayer-artist had entered. *Tobey v. Commissioner*, 60 T.C. 227, 235 (1973). Instead, the Tax Court adhered to the view that the earned income requirement is designed merely to prevent the exclusion of passive income, such as rental income, interest, and dividends, from section 911. *Id.* at 232.

After *Tobey* was decided, the Service issued Revenue Ruling 80-254 wherein the principle enunciated in *Tobey* was applied to authors as well as artists. Rev. Rul. 80-254, 1980-2 C.B. 222. Once the author or artist has the transaction characterized as earned income, then he may defer payment of taxes until this income is actually received.

According to General Counsel Memo 39252, therefore, an artist or author can have income from the sale of his creation treated as earned income for the purpose of deferred compensation. G.C.M. 39252, 24 TAX NOTES at 363. This enables an artist to fall within section 453 of the Code to get installment sales treatment. I.R.C. § 453 (1982 & Supp. III 1985). Section 453, as amended in 1980, removes the impediment of the old law to installment sales treatment of copyrights in exchange for royalties. Now the rule that proceeds of a sale of property are to be valued and taxed currently will not be applied. G.C.M. 39252, 24 TAX NOTES at 363. For a further discussion of G.C.M. 39252, see *supra* notes 126-29 and accompanying text.

154. See *TeLinde v. Commissioner*, 17 T.C. 91 (1952). For a further discussion of *TeLinde*, see *supra* notes 130-36 and accompanying text.

155. See *Tobey v. Commissioner*, 60 T.C. 227 (1973). For a further discussion of *Tobey* and the earned income problem, see *supra* note 153 and accompanying text; *infra* notes 157-58 and accompanying text.

the person acquiring the copyrighted property) must argue that the contract rights he receives in exchange for his copyrighted work are themselves income-producing property.¹⁵⁶ Otherwise, he argues that his contract rights are in fact for future income. In some respects, the artist can manipulate this lack of certainty to his advantage.

The artist's plight is well illustrated by *Tobey v. Commissioner*.¹⁵⁷ The Tax Court in *Tobey* stated, in dicta, that an artist is usually a "hard-working, trained, career oriented individual . . . [who] has keen competition from many other artists who must create and sell their works to survive."¹⁵⁸

Usually, artists lack the time, money and inclination to attempt a contrived form of doing business (such as the creation and sale of contract rights or classifying their income as earned income to fall within the rubric of I.R.C. section 911) in order to avoid paying excessive taxes, only to find that in their particular situation, the form does not work. There is too much uncertainty for the artist in the Tax Code. This environment does not foster creativity. Consequently, we all lose. An inventor, on the other hand, does not face any of this uncertainty. Once he gets the Service to accept his invention as one which comes under the rubric of section 1235, he is home free.

Mandatory Holding Period

The next issue is the mandatory holding period of section 1222. A taxpayer must hold the asset for more than six months before he transfers it in order to realize long-term capital gain.¹⁵⁹ Under the Deficit Reduction Act of 1984, property acquired between June 22, 1984 and December 31, 1987 must be held for six months and one day.¹⁶⁰ In contrast, the "holder" of a patent has no holding period under section 1235: "a transfer of property . . . by any holder shall be considered the sale or exchange of a capital

156. See *Ferrer*, 304 F.2d 125 (2d Cir. 1962); *Benny v. Commissioner*, 25 T.C. 197 (1955). For a further discussion of *Ferrer*, see *supra* notes 87-103, 138-44; *infra* note 265 and accompanying text. For a further discussion of *Benny*, see *infra* notes 266-68 and accompanying text.

157. 60 T.C. 227 (1973). For a further discussion of *Tobey*, see *supra* note 153.

158. *Tobey*, 60 T.C. at 235.

159. I.R.C. § 1222(3) (Supp. III 1985). For the text of section 1222(3), see *supra* note 4.

160. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified at I.R.C. § 1222(1)-(4) (Supp. III 1985)). See H.R. REP. NO. 861, 98th Cong., 2d Sess. 757, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 1445, 1952.

asset held for more than 6 months,"¹⁶¹

Investment Purpose v. Business Purpose

The Supreme Court, in *Burnet v. Harmel*,¹⁶² stated that the policy of taxing capital gains at a lower rate than ordinary income is "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."¹⁶³ The Supreme Court reiterated this policy in *Corn Products Refining Co. v. Commissioner*.¹⁶⁴ The Court, in *Corn Products*, stated that Congress intended the profit from the everyday operation of business to be considered as ordinary income.¹⁶⁵ The preferential treatment of the capital gains provisions of the Code is to apply only "to transactions in property which are not the normal source of business income."¹⁶⁶ Furthermore, the Court stated that

161. I.R.C. § 1235(a) (Supp. III 1985). For the full text of section 1235, see *supra* note 6.

162. 287 U.S. 103 (1932).

163. *Id.* at 106 (citing H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921)). In *Burnet*, the Court held that a lessor's receipts from an oil and gas lease were taxable not as gain from the sale of capital assets, but, rather, as ordinary income. *Id.* at 106. Despite the transfer of the ownership of oil and gas from lessor to lessee which accompanies such a lease, the Court found the receipts to be similar to rental payments. *Id.* The taxation of the lessor's receipts as income, therefore, did not produce the type of hardship involved in the conversion of assets which the capital gains provision seeks to void. *Id.*

The *Burnet* Court's enunciation of the policy behind the capital gains provision was further delineated in the legislative history to I.R.C. § 1221. For a discussion of this legislative history, see *infra* notes 197-202 and accompanying text.

164. 350 U.S. 46 (1955). For a further discussion of *Corn Products*, see *supra* note 104.

165. *Id.* at 52. In *Corn Products*, the Court held that the petitioner's partial "hedging" transactions involving purchases and sales of corn futures to insure against loss by unfavorable changes in the market price of a commodity did not constitute capital asset transactions. *Id.* at 47, 49-50. Finding the transactions to be an integral part of the petitioner's manufacturing business, the Court held that they did not deserve the capital asset treatment accorded property which is not the normal source of business income. *Id.* at 51-52. The resulting gains and losses from the transactions, therefore, were to be treated as ordinary income and ordinary deductions. *Id.* at 47.

The Court's decision in *Corn Products* has given rise to what has been termed the "*Corn Products* doctrine": partial hedging by a manufacturer whose raw materials are a commodity being traded are to be treated as if they were inventory and not as a capital asset. Traditional capital assets, therefore, will be taxed as ordinary assets based on the taxpayer's purpose in acquiring them. For a further discussion of "hedging" and the "*Corn Products* doctrine," see 3B J. MERTENS, *supra* note 15, § 22.14; Note, *Taxation of Commodity Futures Used as Hedges*, 13 TAX L. REV. 87 (1957); Javaras, *Corporate Capital Gains and Losses—The Corn Products Doctrine*, 52 TAXES 770 (1974).

166. 350 U.S. at 52.

“since [section 117] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly.”¹⁶⁷ Essentially, therefore, a capital transaction must be for an investment purpose as opposed to a business purpose.

The enactment of I.R.C. section 1235 occurred prior to the *Corn Products* decision, but after *Burnet v. Harmel*. *Corn Products* clearly affirmed the Court’s position on the policy of relieving tax burdens which are due as a result of investments in contrast to profit from business.¹⁶⁸ Yet, in enacting section 1235, Congress seemingly went against its own stated policy and that of the Supreme Court.¹⁶⁹ Through section 1235, Congress allowed an inventor, who may be in the *business* of inventing, to shield a substantial portion of his business profits under the capital asset classifications for patents and inventions with its deemed sale and holding period.¹⁷⁰

Capital Gain Treatment for Appreciation of Purchased Property

One final important factor which has influenced the characterization of a transaction is the tax policy to treat appreciation in the value of a capital asset as a capital gain upon the asset’s sale. This policy was initiated to lessen the hardship of taxation which occurs when the appreciation which has accumulated over the years is realized in the year of conversion.¹⁷¹

167. *Id.* In thus narrowly applying the definition of capital assets and broadly interpreting the exclusions of section 117, the Court expressly sustained the exclusion from capital assets of futures dealt in for hedging purposes. *Id.*

168. *Id.*

169. For a discussion of Congressional reasons behind the enactment of section 1235, see *infra* notes 242-49 and accompanying text.

170. For the full text of section 1235, see *supra* note 6.

171. *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960). The Supreme Court had recognized the Congressional purpose to afford capital gain treatment “in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and then to ameliorate the hardship of taxation of the entire gain in one year.” *Id.*; see also *Holt v. Commissioner*, 35 T.C. 588 (1961) (finding “[t]he leniency [toward] taxation of capital gains has its genesis in the theory that it would be inequitable to tax all the increase in value of a capital asset, which has occurred over a number of years, in the year in which it is converted”), *aff’d*, 303 F.2d 687 (9th Cir. 1962). For a discussion of the Congressional policy affording capital gain treatment only in situations involving appreciation in value which has accrued over a substantial period of time in order to ease the hardship of taxing the entire gain in one year, see W. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 75-78 (1976). For a further discussion of *Holt*, see *supra* notes 107-14 & 146 and accompanying text.

B. *Provisions Other than I.R.C. Section 1235 Which Specifically Benefit Inventors*

In addition to the capital gains provisions of the Code, many other provisions discriminate in favor of inventors and patentees and against artists and authors. One such provision is section 174¹⁷² which governs the treatment of research and experimental expenditures. Under section 174, a taxpayer may either deduct or amortize the research and experimental expenditures which were paid or accrued "in connection with his trade or business."¹⁷³ In order to take advantage of section 174, however, section 162 requires that the taxpayer be "engaged in carrying on a trade or business."¹⁷⁴ The taxpayer may take the deduction or he may elect to amortize his expenses.¹⁷⁵ A patent need not have been issued nor even applied for because even the business-related expenses for self-development of know-how qualify for deductions under section 174.¹⁷⁶

The Treasury Regulations define "research and experimental expenditures" to mean "research and developmental costs in the experimental or laboratory sense."¹⁷⁷ The term includes gener-

172. I.R.C. § 174 (1982). For the relevant text of section 174(a), see *supra* note 18.

173. I.R.C. § 174 (1982).

174. *Id.* § 162 (1982 & Supp. III 1985). Section 162(a) provides, in pertinent part: "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" *Id.* For a discussion of the distinctions between section 162 requirements and section 174 requirements, see Morreale, *supra* note 46, at 564.

175. I.R.C. § 174 (1982). Should the taxpayer elect to amortize his research or experimental expenses, he may write them off over a period of not less than sixty months, beginning with the month in which benefits are first realized. *Id.* § 174(b)(1).

Expenditures treated as deferred expenses under section 174(b)(1) are chargeable to capital account and increase the basis of the property to which they relate. The basis so adjusted is reduced by the amount of [research or experimental expenses] allowed as deductions which results in a reduction of the taxpayer's taxes, but not less than the amount allowable for the taxable year and prior years.

4 FED. TAXES (P-H) ¶ 16,206 (1986); see also I.R.C. § 1016(a)(14) (1982).

176. For a discussion of the deductibility under section 174 of business related expenditures for the self-development of know-how, see Morreale, *supra* note 46, at 564-65.

177. Treas. Reg. § 1.174-2(a) (1960). The regulation provides, in pertinent part:

(a) In general.

(1) The term "research or experimental expenditures", as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or

ally all such costs incident to the development of an experimental or pilot model, a plant process, a producer, a formula, an invention, or similar property, and the improvement of an already existing property of the type mentioned.¹⁷⁸ Furthermore, the term includes costs incurred in securing a patent, such as attorney's fees.¹⁷⁹ The regulations specifically exclude, however, the expenses paid or incurred for research in connection with literary or historical projects.¹⁸⁰

The Code also provides a credit in section 30 for research and experimental expenditures paid or incurred after June 30, 1981.¹⁸¹ This credit is available regardless of whether the tax-

pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising or promotions. However, the term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. On the other hand, the term does not include the costs of acquiring another's patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

(2) The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition of improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership. . . .

Id.

178. *Id.*

179. *Id.*

180. *Id.*

181. I.R.C. § 30 (Supp. III 1985) (renumbering I.R.C. § 44F (1982)).

I.R.C. section 30 provides, in pertinent part:

(a) General Rule—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 25 percent of the excess (if any) of—

- (1) the qualified research expenses for the taxable year, over
- (2) the base period research expenses.

(b) Qualified Research Expenses—For purposes of this section—

(1) Qualified Research Expenses—The term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer—

- (A) in-house research expenses, and
- (B) contract research expenses.

payer has elected under section 174 to deduct or amortize ex-

(2) In-house Research Expenses—

(A) In General—The term “in-house research expenses” means—

- (i) any wages paid or incurred to an employee for qualified services performed by such employee,
- (ii) any amount paid or incurred for supplies used in the conduct of qualified research, and
- (iii) any amount paid or incurred to another person for the right to use personal property in the conduct of qualified research.

Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property.

(B) Qualified Services—The term “qualified services” means services consisting of—

- (i) engaging in qualified research, or
- (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term “qualified services” means all of the services performed by such individual for the taxpayer during the taxable year.

(C) Supplies—The term “supplies” means any tangible property other than—

- (i) land or improvements to land, and
- (ii) property of a character subject to the allowance for depreciation.

(D) Wages—

(i) In General—The term “wages” has the meaning given such term by section 3401(a).

(ii) Self-Employed Individuals and Owner-Employees—In the case of an employee (within the meaning of section 401(c)(1), the term “wages” includes the earned income (as defined in section 401(c)(2)) of such employee.

(iii) Exclusion for Wages to Which New Jobs or Win Credit Applies—The term “wages” shall not include any amount taken into account in determining the targeted jobs credit under section 51(a).

(3) Contract Research Expenses—

(A) In General—The term “contract research expenses” means 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.

(B) Prepaid Amounts—If any contract research expenses paid or incurred during any taxable year are attributable to qualified research to be conducted after the close of such taxable year, such amount shall be treated as paid or incurred during the period during which the qualified research is conducted.

(c) Base Period Research Expenses—For purposes of this section—

(1) In General—The term “base period research expenses” means the average of the qualified research expenses for each year in the base period.

penditures.¹⁸² To qualify, the taxpayer must pay or accrue expenses during the taxable year "in carrying on any trade or business."¹⁸³ In defining "qualified research expenditures," the Code specifically excludes any research "in the social sciences or humanities."¹⁸⁴ Also, under the Accelerated Cost Recovery System ("ACRS") for depreciation, machinery and equipment used for experimentation and research (as defined in I.R.C. section 174) is given a three year recovery period as opposed to the longer five, ten, or eighteen year periods used previously.¹⁸⁵

Furthermore, the Code's treatment of compensatory dam-

(2) Base Period—

(A) In General—For purposes of this subsection, the term "base period" means the 3 taxable years immediately preceding the taxable year for which the determination is being made (hereinafter in this subsection referred to as the "determination year").

(B) Transitional Rules—Subparagraph (A) shall be applied—

(i) by substituting "first taxable year" for "3 taxable years" in the case of the first determination year ending after June 30, 1981, and

(ii) by substituting "2" for "3" in the case of the second determination year ending after June 30, 1981.

(3) Minimum Base Period Research Expenses—In no event shall the base period research expenses be less than 50 percent of the qualified research expenses for the determination year.

(d) Qualified Research—For purposes of this section the term "qualified research" has the same meaning as the term research or experimental has under section 174, except that such term shall not include—

(1) qualified research conducted outside the United States

(2) qualified research in the social sciences or humanities, and

(3) qualified research to the extent funded by any grant, contract, or otherwise by another person (or any governmental entity) . . .

Id.

182. 4 FED. TAXES (P-H) ¶ 16,206 (1986). For a further discussion of a taxpayer's ability to deduct or amortize research and experimental expenditures, see *supra* note 175 and accompanying text.

183. I.R.C. § 30(b)(1) (Supp. III 1985). For the text of section 30(b)(1), see *supra* note 172.

184. I.R.C. § 30(d)(2) (Supp. III 1985). For the text of section 30(d)(2), see *supra* note 181.

185. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified at I.R.C. § 168 (1982 & Supp. III 1985)). This Act created the Accelerated Cost Recovery System (ACRS) for depreciable property. *Id.* § 201. Under ACRS, the capital cost of property is written off over statutory recovery periods. I.R.C. § 168. For personal property such as machinery and equipment used for research and experimentation under I.R.C. § 174, ACRS provides a three-year recovery period. *Id.* § 168(c)(2)(A). As an option, however, a taxpayer may recover costs using the straight line method of depreciation rather than using the recovery periods provided by ACRS. *Id.* § 168(f)(2)(C). The enactment of ACRS sought to provide investment stimulus in the face of the decreasing value of depreciation deductions due to inflation. For a further discussion of ACRS, see S. REP. NO. 97-144, 97th Cong., 1st Sess. 39-68, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 145-173; 4 FED. TAXES (P-H) ¶ 16,206 (1986).

ages for patent infringement is preferential. Before I.R.C. section 1304 was repealed in 1964, a taxpayer was allowed to treat the damages payment as if it had been ratably received over the years during which the infringement occurred.¹⁸⁶ Under the present tax structure, the taxpayer who is awarded damages for patent infringement may consider those payments as if they were payments for the transfer of the patent (i.e., as capital gain).¹⁸⁷ Since copyrighted property does not fit within I.R.C. section 1235, the Code contains no specific provision for the humanities concerning compensatory damages received from infringement cases as it does with patents. Furthermore, a Tax Court memorandum decision concerning copyrights held that the proceeds of a settlement resulting from an exploitation of a radio program package were to be treated as ordinary income.¹⁸⁸

Another significant tax discrimination against artists occurred when Congress passed the Tax Reform Act of 1969.¹⁸⁹ Prior to the passage of that Act, an artist could make a charitable contribution of his work and realize no income either upon its

186. I.R.C. § 1304 (1958), *repealed by* Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 22. The original section 1304, which was in effect between 1954 and 1964, provided in pertinent part:

If an amount representing compensatory damages is received or accrued by a taxpayer during a taxable year as the result of an award in a civil action for infringement of a patent issued by the United States, then the tax attributable to the inclusion of such amount in gross income for the taxable year shall not be greater than the aggregate of the increases in taxes which would have resulted if such amount had been included in gross income in equal installments for each month during which such infringement occurred.

Id.

187. Treas. Reg. § 1.1235-1(c)(1) (1960). For the full text of section 1.1235-1(c)(1), see *supra* note 20.

188. See *Kurlan v. Commissioner*, 22 T.C.M. (CCH) 1445, 1448 (1963), *aff'd*, 343 F.2d 625 (2d Cir. 1965). In *Kurlan*, the petitioner, an independent writer and producer of radio and television programs, submitted to Columbia Broadcasting System, Inc. (CBS) a sample recording for a radio program based on characters from a literary property known as "my Sister Eileen." After refusing to buy the program from the petitioner, "CBS subsequently produced a weekly television program . . . entitled "My Friend Irma," which petitioner allege[d] was similar to [his] radio program. . . ." 22 T.C.M. at 1446. The petitioner commenced an action against CBS alleging infringement of his property rights in the radio program. *Id.* at 1446-47. He ultimately settled with CBS for \$75,000. *Id.* at 1446.

Finding the settlement payment to be compensation to the petitioner for any possible wrongful use by CBS of his radio program, the Tax Court held that the \$75,000 was to be treated as ordinary income since rights to compositions of a literary nature are "not property which falls within the section 1221 definition of capital asset. . . ." *Id.* at 1448.

189. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

contribution or upon later disposition of the work by the donee.¹⁹⁰ The artist was further "entitled to a charitable deduction . . . equal to the fair market value of the work transferred."¹⁹¹ The Tax Reform Act of 1969 reduced the deduction for all gifts of property by the amount that would have been ordinary income if the donor had sold the property at its fair market value.¹⁹² As a result, the artist may now deduct only the actual costs of his canvases and oils. Additionally, the artist may not claim that the charitable contribution was a necessary business expense, deductible under section 162, even if the gift was intended to promote the artist's sales.¹⁹³ Collectors of art, on the other hand, may deduct the full fair market value of their charitable dispositions. Their deduction is not limited to the cost of the work.¹⁹⁴

190. Beghe, *The Artist, The Art Market and Income Tax*, 29 TAX L. REV. 491, 505, 514 (1974) (footnotes omitted). President Nixon, in fact, donated his vice presidential papers and got the full fair market value as a deduction before the passage of the Tax Reform Act of 1969. *Id.* at 516 (footnotes omitted).

191. *Id.* at 514. For a discussion of the applicability of the charitable contribution deduction to a donor artist, see Beghe, *supra* note 83, at 514. Professor Beghe noted three benefits to the donor artist prior to the Tax Reform Act of 1969: 1) the artist realized no income on disposition; 2) the artist could deduct the fair market value of the transferred work; and 3) if the work was produced in a previous year, the amount of the deductions was not reduced by previously claimed deductions. *Id.* (Footnote omitted); see also Rudick & Gray, *Bounty Twice Blessed: Tax Consequences of Gifts of Property to or in Trust for Charity*, 16 TAX. L. REV. 273 (1961) (noting the latter two benefits).

192. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(E)(1)(A), 83 Stat. 487, 555 (1969). In the 1969 Act, Congress amended I.R.C. § 170(e) to limit the charitable contribution deduction. See I.R.C. § 170(e)(1)(A) (1982). Section 170(e)(1)(A) currently states:

- (1) The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by . . .
- (A) not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution), . . .

Id.

193. See Edelstein and Mott, *Tax Problems*, in LEGAL AND BUSINESS PROBLEMS OF ARTISTS, ART GALLERIES AND MUSEUMS 659 (1973).

194. See Speiller, *The Favored Tax Treatment of Purchasers of Art*, 80 COLUM. L. REV. 214 (1980). Professor Speiller examines the law and practice by which purchasers of art can take advantage of the benefits of favorable tax treatment. The author notes that a great benefit is the availability of a charitable deduction for the appreciated value of an art work at the time of the gift. *Id.* at 216-17 (footnotes omitted); see also Mansfield & Groves, *Legal Aspects of Charitable Contributions of Appreciated Property to Public Charities*, in 4 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, U.S. DEPT. OF THE TREASURY, RESEARCH PAPERS 2551, 2551-52 (1977) (discussing history of permitting charitable contribution deduction of appreciated fair market value).

III. LEGISLATIVE HISTORIES

Having examined in detail the current laws that are pertinent to copyrights and patents, a discussion of the relevant legislative history to those laws is now in order. The examination of the legislative histories will reveal why Congress enacted these laws, or at least, what Congress has chosen to state as its reasons for their enactment.

A. *Capital Gain Concept*

Congress introduced the concept of capital gain into the Tax Code in the Revenue Act of 1921.¹⁹⁵ In the general comment issued by the House Ways and Means Committee, the House of Representatives stated that the purpose of the Act was to reduce rather than shift the tax burden because "[t]he reduction of tax burdens is essential to business recovery. . . ."¹⁹⁶

The predecessor to the present I.R.C. section 1221 was section 206(a)(6) of the 1921 Code.¹⁹⁷ This section defined a "capital asset" to include property acquired and held by the taxpayer for more than two years as an investment or for profit, whether or not connected with his trade or business, but not property held for personal use or inventory.¹⁹⁸ The report of the Ways and

195. Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227 (1921).

196. H.R. REP. NO. 350, 67th Cong., 1st Sess. 1 (1921). In setting forth the purpose of the Revenue Act, the committee stated:

With few minor exceptions, new tax levies . . . have been avoided. In the opinion of your committee the exacting of the present excessive sums of taxes from the country contributes in no small degree to the depressing influences under which business and industry in general are staggering as an aftermath of the World War. The cost of the war, the extent of its destruction, and the financial cost it occasions, is felt, not during the period of combat but after the cessation of hostilities, at which time the demand for war supplies terminates, with a resulting shrinkage of values. The Nation is now passing through the trying period of liquidation and readjustment. The reduction of the tax burdens is essential to business recovery. . . .

Id.

197. Revenue Act of 1921, Pub. L. No. 67-98, § 206(a)(6), 42 Stat. 227, 233 (1921); *see* I.R.C. § 1221 (1982) Revenue Act of 1921, Pub. L. No. 67-98, § 206(a)(6), 42 Stat. 227, 233 (1921).

198. *Id.* This section provided in full:

The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

Id.

Means Committee stated that this section was necessary because sales were retarded.¹⁹⁹ The gain earned over a number of years was taxed as a lump sum in the year of realization.²⁰⁰ The purpose of section 206(a)(6) was to permit a transaction to be completed without the prohibitive tax.²⁰¹ The Senate Finance Committee's report reiterated this purpose and added that this section limited the rate of taxation on gain derived from a sale of a capital asset by providing that only forty percent of the net gain derived would be taxed.²⁰²

The congressional discussions which followed the presentation of this provision and other related provisions serve to illumi-

199. H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1961 at 813 (1938). In its report, the committee found that "[t]he sale of farms, mineral properties, and other capital assets is now seriously retarded. . . ." *Id.*

200. *Id.* The committee stated that the reason for the retardation of sales was:

that gains and profits earned over a series of years are under the present law taxed on a lump sum . . . in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law.

Id. at 10-11, *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1961, at 813 (1938).

201. *Id.* at 11, *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1961, at 813 (1938). The committee explained:

In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section . . . to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains.

Id.

202. S. REP. NO. 275, 67th Cong., 1st Sess. 12 (1921), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1961, at 814 (1938). The Senate Committee stated that:

Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are . . . taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206 provides that only 40 per cent of the net gain derived from the sale or other disposition of capital assets shall be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 per cent.

Id.

nate the capital gain concept generally. Senator Walsh of Massachusetts had difficulty understanding why a lawyer or any other professional person who derived a fee from a large case was taxed for the full amount, while a speculator who derived the same amount of income from the New York Stock Exchange would only be taxed on forty percent.²⁰³ He continued to state that if this proposal had any merit at all, then fairness to other taxpayers demanded that there should be a required holding period.²⁰⁴

B. *The Revenue Act of 1950: Exclusion of Copyrights From Definition of Capital Asset*

The Revenue Act of 1950 made several amendments to the capital asset definitional sections of the Code which were particularly harmful to authors and artists. These amendments formed the backdrop for Congress' enactment of section 1235, in 1954, which once and for all evidenced Congress' desire to benefit inventors at the expense of authors and artists.²⁰⁵

Prior to the enactment of the Revenue Act of 1950, the main hazard an author or artist faced in qualifying for capital gain treat-

203. 61 CONG. REC. § 6575 (1921) (statement of Senator Walsh). In his remarks to the Senate, Senator Walsh specifically stated:

... [t]he abuses that can grow out of the proposed change would seem to argue very strongly against the insertion of this clause without some modification in the pending bill. There is no distinction made between increased value in tangible or intangible property extending over a long period of years and that sudden and speculative increase that develops within a short period of time. Under this amendment the stock speculator who buys early in the year stocks at a small valuation and sells them later at a much enhanced value would have to pay a tax on only 40 per cent of the gain from such sales, while gains in income from every other source of income would be taxed to the full amount.

Under the proposed amendment and bill a lawyer or any other professional man who derived as a fee from a large case or a merchant who through a substantial increase in sales derived an income of, say, \$100,000 per year is taxable upon the full amount of income. The speculator who derives an income of \$100,000 a year upon the New York Stock Exchange or in any other manner would be taxable only on 40 per cent of his net income, or \$40,000.

Id. (statement of Senator Walsh).

204. *Id.* Senator Walsh proposed that:

[I]n all fairness and equity to taxpayers other than those who are making money in a speculative way upon sudden increases in the value of property which they hold that there should be a limit in the time allowed for holding capital assets before the reduced rate of taxation would be applicable. . . . a time limit of at least three years.

Id. (statement of Senator Walsh).

205. For a discussion of the purpose and history of section 1235, see Mott, *supra* note 24, at 151-52; see also *supra* note 6 (Text of I.R.C. § 1235).

ment when he disposed of his property was the provision which withheld capital gain treatment for property held by the taxpayer "primarily for sale to customers in the ordinary course of business."²⁰⁶ A professional author or inventor was deemed to hold the products of his efforts as goods for sale in his business so that he was, therefore, not eligible for capital gain treatment when he transferred that property.²⁰⁷ On the other hand, an amateur author or inventor in the field who produced and sold only a few works might be deemed to realize capital gain on the sale or exchange of his works since he was not "in the business" of producing and selling his works.²⁰⁸

To avoid this loophole which was available to amateur authors and artists, the Revenue Act of 1950 specifically excluded from the definition of capital asset *all* copyrighted property (and all property which might be entitled to copyright protection) which was held by a taxpayer whose personal efforts created the property or by a taxpayer in whose hands the basis of such property is determined by reference to the basis in the hands of the creator.²⁰⁹ Section 206(a)(6) of the 1921 Code had come under the rubric of section 117 of the 1939 Code: Capital Gains and Losses.²¹⁰ The 1950 bill which finally passed through the House amended the definition of "capital asset" to read: "The term 'capital assets' does *not* include . . .

206. Revenue Act of 1942, Pub. L. No. 77-753, § 151(b), 56 Stat. 798, 846 (1942) (enacting I.R.C. § 117(j)). Under I.R.C. § 117(j)(1) (the predecessor section to section 1231(b)), "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business was expressly excluded from the statutory definition of "property used in the trade or business." Revenue Act of 1942, Pub. L. No. 77-753, § 151(b), 56 Stat. 798, 846. Such property, therefore, was denied the benefits of section 117(j)(2) which treated a taxpayer's gains and losses from dispositions of section 117(j) business assets as long-term capital gains and losses if the total gains exceeded the total losses. *Id.* The current I.R.C. section 1231(a) makes similar provisions for such treatment of business assets. See I.R.C. § 1231(a) (Supp. III 1985).

207. 3B J. MERTENS, *supra* note 15, at § 22.19.

208. *Id.*; see also *Herwig v. United States*, 105 F. Supp. 384 (Ct. Cl. 1952) (author realized capital gain on the sale of her novel since she did not hold such property primarily for sale to customers in the ordinary course of business); *TeLinde*, 18 T.C. 91 (1952) (author realized capital gain upon the sale of his work); *Filpel*, TAX LAW., *supra* note 60. For a further discussion of the *TeLinde* case, see *supra* notes 130-136 and accompanying text.

209. Revenue Act of 1950, Pub. L. No. 81-814, § 210, 64 Stat. 906, 932-33, *reprinted in* 1950 U.S. CODE CONG. SERVICE 509-10 (amending Internal Revenue Code of 1939, Pub. L. No. 76-1 § 117(a)(1), 53 Stat. 1, 50 (1939)) (emphasis added).

210. Revenue Act of 1921, Pub. L. No. 67-98 § 206(a)(6), 42 Stat. 227, 233 (1921); Internal Revenue Code of 1939, Pub. L. No. 76-1, § 117, 53 Stat. 1, 50 (1939).

....

(C) a patent [deleted] or copyright; an invention [deleted] or design [deleted] a literary, musical, or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, . . .²¹¹

The report of the House Ways and Means Committee reveals that Congress intended to exclude from the definition of a capital asset *all* property held by any taxpayer whose personal efforts had created it.²¹² Patents as well as copyrights were added to the exclusion of section 117 and, therefore, excluded from the definition of "capital asset."²¹³ The House did away with the distinction between an amateur author or inventor and a professional author or inventor, stating that "a person who devises an invention or who writes a book or creates some other sort of artistic work will be taxed at ordinary income rates, . . . whether it is his first product in the field or not."²¹⁴ The House apparently wanted to close the loophole which allowed any amateur, whether author or inventor, to realize capital gain.

The Senate Finance Committee referred to the 1950 bill as

211. Revenue Act of 1950, Pub. L. No. 81-814, § 210(a), 64 Stat. 906, 932 (1950), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS: 1953-1939, at 1763 (1954) (emphasis added).

As a point of interest, the amendment to close the "amateur" loophole has been referred to as the "Eisenhower Amendment" because its introduction was stimulated by the capital gain realized by General Eisenhower as an amateur author on the sale of his book, *Crusade in Europe*. 3B J. MERTENS, *supra* note 15, at § 22.19 n.7; *see also* Mott, *supra* note 24, at 150-51, Pilpel, *TAX LAW*, *supra* note 60, at 76.

212. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 92 (1950), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS: 1953-1939, at 1764 (1954) (emphasis added). The Committee Report stated:

The definition of the term "capital assets" has been . . . amended to exclude certain property created by the personal efforts or exertions of the taxpayer. Under the committee amendment a person who devises an invention or who writes a book or creates some other sort of artistic work will be taxed at ordinary income rates, rather than at capital gains rates, upon gain from the sale of the work. . . .

Id.

213. *Id.* The Committee Report further explained that:

. . . the bill lists specifically patents [sic], copyrights, inventions, designs, and literary, musical, or artistic compositions as property intended to be excluded from the capital asset category. The amendment will also exclude any property similar to that specifically named; for example, a formula or a radio program which has been created by the personal efforts of the taxpayer.

Id.

214. *Id.*

one which included many “loophole-closing measures.”²¹⁵ This was particularly important since there was a need at that time to raise taxes because of the war in Korea.²¹⁶ However, the Senate, in its report, did not include patents in the exclusionary language of section 117 and, therefore, did not exclude patents from the definition of a capital asset. Rather, it spoke only of the person “in the profession of writing books or creating other artistic works” and stated that the income from the sale of products created by personal effort should be taxed as ordinary income.²¹⁷ The Senate Finance Committee agreed that the policy of taxing the products of an artist’s personal efforts should apply to the amateur artist as well, who, under the present tax structure, could avail himself of a loophole if he held his creation for six months.²¹⁸ He could then sell it and realize capital gain treatment.²¹⁹ Furthermore, to avoid another loophole, any gain realized by a person who acquired the artistic work as a gift from the artist could be taxed as ordinary income.²²⁰

When the Senate Finance Committee report finally made mention of patents and inventions, it was to say that the proposed House bill wrongly excluded those assets from the definition of capital asset. The Finance Committee believed that the “desirability of fostering the work of such inventors outweigh[ed] the

215. S. REP. NO. 2375, 81st Cong., 2d Sess. 1 (1950), *reprinted in* 1950 U.S. CODE CONG. SERVICE 3053.

216. *Id.* The Senate Finance Committee found that “[m]ilitary action in Korea coupled with substantial increases in defense and related expenditure has made it necessary to convert the excise tax reduction bill passed by the House in June of this year into a bill to raise revenues.” *Id.*

217. *Id.* at 3097. The committee stated that:

When a person is in the profession of writing books, of creating other artistic works, his income from the sale of the products of his work is taxed as ordinary income. This is true whether he receives royalties from the use of his products or sells them outright, since the products of his work are held by him “primarily for sale to customers in the ordinary course of his trade or business” and are, therefore, not treated as capital assets.

Id.

218. *Id.*

219. *Id.* The Finance Committee Report explained that:

If an amateur receives royalties on his book or other artistic work, they are treated as ordinary income, but if he holds his book or other artistic work for 6 months . . . and then sells it outright he can avail himself of a loophole which treats such a sale as the sale of a capital asset, not held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. As a result the taxpayer receives long-term capital gain treatment on the product of his personal effort.

Id.

220. *Id.*

small amount of additional revenue which might be obtained under the House bill. . . ."²²¹ Therefore, the words "invention," "patent," and "design" were eliminated from the proposed bill.²²²

At the Senate Hearings on the Revenue Revisions of 1950,²²³ statements were made by various individuals and groups which greatly influenced the Finance Committee's decision to delete "patents and inventions" from the bill proposed by the House Ways and Means Committee. The table of contents to the hearings indicates that the arts were not well represented. Those who did appear to support the arts were individuals primarily involved with the performing arts. In fact, an examination of their statements reveals that they were present at the hearings to object to a proposed ticket sales tax rather than to lobby for the same preferential treatment granted to inventors.²²⁴

On the other hand, small business and industry were represented by the Council for Independent Business and by the Patent Association, each of which made statements pertinent to the proposed bill to exclude patents from the definition of capital assets. Mr. C.E. Earle, Secretary-Treasurer of the Council for Independent Businesses and President of Breco Manufacturing Company, announced that individuals engaged in the production of wealth in this country under the protection of the patent system were "very alarmed" by the bill which "would prohibit an inventor from treating his patent as a capital asset."²²⁵ In Mr.

221. *Id.* at 3098.

222. *Id.*

223. Revenue Revisions of 1950, *Hearings on H.R. 8920: An Act to Reduce Excise Taxes and for Other Purposes, Before the Committee on Finance United States Senate*, 81st Cong., 2d Sess. (1950).

224. *See id.* at 165. In her statement before the Finance Committee, Helen M. Thompson, Manager of the Charleston Symphony Orchestra and Secretary-Treasurer of the American Symphony Orchestra League, expressed the "grave financial need for the proposed exemption" of nonprofessional orchestras from "the twenty percent Federal excise tax on admission tickets to our concerts." *Id.*; *see also id.* at 170. Representing the League of New York Theatres and the National Association of the Legitimate Theater, James F. Reilly stated that relief should be given the entertainment industry "by way of an exemption" from the ticket sales tax. *Id.*

225. *Id.* at 601-02 (statement of C.E. Earle). Mr. Earle also stated that: [T]he experts who wrote this provision call it plugging up a loophole. Permitting an inventor to get some reward for his invention is not my idea of a loophole. As for 'plugging up', it will certainly effectively plug up the inventor's desire to create new and better things for our people to enjoy.

Id. at 605. Mr. Earle continued by stating that "the inventor flourishes and

Earle's opinion, "inventions [were] wholly an industrial tool."²²⁶ He further added that the amount of revenue raised by taxation of patents when treated as ordinary income assets was slight.²²⁷

Tax attorney Allan Higgins also stated that the bill before the Senate which proposed to tax the proceeds of all patents and copyrights by inventors and authors was "discriminatory, arbitrary, and a great discouragement to inventive and creative genius in the United States."²²⁸ Furthermore, he concluded, in order to maintain the United States' lead in scientific advancement, inventors should be given every encouragement possible.²²⁹

The statement submitted by the American Patent Law Association in opposition to the proposed provisions of the bill also appealed to the potential danger of stifling inventive ingenuity.²³⁰ In retrospect, it is apparent that the lobbying efforts of the propo-

brings forth fruit when he feels that he is being nurtured in an atmosphere of freedom and a soil rich in opportunity." *Id.*

226. *Id.* at 605 (statement of C.E. Earle). Moreover, added Mr. Earle:

Our patent system is responsible, to a large degree, for the tremendous and rapid growth of the industrial phase of our economy. Although the individual inventor has never been properly rewarded for his advanced thinking, vision, and personal efforts, he deserves the major part of the credit for this great progress. His type of thinking should be encouraged rather than discouraged.

Id. at 603 (statement of C.E. Earle).

227. *Id.* at 605 (statement of C.E. Earle). Mr. Earle asserted that:

If patents produce their proportionate share, it will only amount to a couple of hundred thousand dollars. [sic]. For this comparatively picayune sum we would discourage our individual inventor by putting a ceiling over his opportunities, thus inhibiting his desire to create by depriving him of the major part of the reward, which is already pitifully small. So the end result will be to deny the economy of this nation many inventions potentially worth millions of dollars, to say nothing of the loss of patent stimuli to our industrial developments.

Id. Mr. Earle concluded by "respectfully and urgently" requesting the Senate Finance Committee "to delete the words 'a patent or an invention or design' from the proposed bill." *Id.*

228. *Id.* at 607 (statement of Allan H.W. Higgins).

229. *Id.* at 608 (statement of Allan H.W. Higgins). Mr. Higgins suggested that, "[i]n these times, when it is so important for the United States to keep the lead in new scientific development in all fields, inventors, especially, should be given every encouragement possible rather than be subjected to a new arbitrary tax provision which will dull and discourage their inventive genius." *Id.*

230. *Id.* at 680 (statement of American Patent Law Association). The Association stated that the proposed bill:

would be discriminatory against inventors and would work a hardship tending to retard rather than stimulate inventive ingenuity . . . [it] would strike hardest at the 'little inventor' who in many instances works for many years on the development of an idea which when brought to fruition may be, and often is, the only invention of value which he produces in his lifetime. If he is fortunate enough to sell his invention or the patent which he obtains on it, it would be manifestly unfair to make

nents of the patent system were not in vain since the Senate Finance Committee acquiesced and deleted the words "patent," "invention," and "design" from the proposed bill, using the reasoning of the lobbyists to justify its actions.²³¹

Besides the loophole for amateur artists, Congress plugged other loopholes with the Revenue Act of 1950. Section 341 of the present Code²³² had its genesis in this Act as section 117(m) of the amended 1939 Code.²³³ This provision defined a collapsible corporation as a device whereby one or more individuals attempts to convert his profits to long-term capital gain. This is accomplished by forming a corporation principally for the production or construction of property, with a view to distribution before the corporation realizes a substantial part of the net income to be derived from the property.²³⁴ Section 117(m)(1) further provided that the gain from the sale or exchange of stock of a collapsible corporation would be treated as a sale or exchange of

him pay tax on the entire amount received as income rather than as sale of a capital asset.

231. 1950 U.S. CODE CONG. SERVICE 3097-98. The legislative history of the Revenue Act of 1950 reveals that the deletion of the words "invention," "patent," and "design" was due to the belief "that the desirability of fostering the work of [occasional] inventors outweighs the small amount of additional revenue which might be obtained" *Id.* at 3098.

232. I.R.C. § 341 (1982).

233. Revenue Act of 1950, Pub. L. No. 81-814, § 212(a), 64 Stat. 906, 934-35 (enacting I.R.C. § 117(m)). The purpose of section 117(m) was to close a loophole that Congress feared could be used to convert ordinary income into capital gain. See *Braunstein v. Commission*, 36 T.C. 22, *aff'd*, 305 F.2d 949 (2d Cir. 1962), *aff'd*, 374 U.S. 65 (1963).

234. Revenue Act of 1950, Pub. L. No. 81-814, § 212, 64 Stat. 906, 934-35, (enacting I.R.C. § 117(m)), *reprinted in* 1950 U.S. CODE CONG. SERVICE 512. Section 117(m), as added by the 1950 Revenue Act, provided, in pertinent part:

(2) Definitions—

(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

- (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and
- (ii) the realization by such shareholders of gain attributable to such property.

Id. For the text of the current code section dealing with collapsible corporations, see *infra* note 287.

property which was not a capital asset.²³⁵ This new section 117(m) prevented artists from forming a corporation which held their works as assets and then selling their shares in the corporation in order to realize long-term capital gain.

Another plugged loophole, also at the expense of artists, was the amendment of section 117(j) of the 1939 Code, the precursor to the present section 1231(b).²³⁶ Section 117(j) was entitled "Gains and Losses from Involuntary Conversion and from Sales or Exchanges of Certain Property Used in the Trade or Business."²³⁷ In 1950, Congress amended section 117(j) by excluding from the definition of "property used in the trade or business" copyrights and literary, musical or artistic compositions and similar property in the hands of a taxpayer whose personal efforts cre-

235. Revenue Act of 1950, Pub. L. No. 81-814, § 212, 64 Stat. 906, 934-35. Section 117(m)(1) provided that:

(1) Treatment of gain to shareholders—gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall be considered as gain from the sale or exchange of property which is not a capital asset.

Id.

In its report, the Senate Finance Committee stated that the device of the collapsible corporation had been used primarily by the motion-picture industry. See S. REP. NO. 2375, 81st Cong., 2d Sess., reprinted in 1950 U.S. CODE CONG. SERVICE 3099. For a further discussion of use of the collapsible corporation by artists, see *infra* notes 282-85 and accompanying text.

236. Revenue Act of 1950, Pub. L. No. 81-814, § 210, 64 Stat. 906, 933 (amending Revenue Act of 1942, Pub. L. No. 42-753, § 151(b), 56 Stat. 798, 846 (1942)), reprinted in 1950 U.S. CODE CONG. SERVICE 510. Section 117(j) of the 1939 Code was thus amended to provide as follows:

(j) Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.

(l) Definition of property used in the trade or business—For the purpose of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation . . . , held for more than six months, which is not (A) property of a kind which would be properly includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(c). (A taxpayer whose personal efforts created such property or a taxpayer whose basis in such property is determined with reference to the basis of such property in the hands of the person whose personal efforts created such property) (explanation added).

Id.

237. Revenue Act of 1942, Pub. L. No. 42-753, § 151(b), 56 Stat. 798, 846 (1942) (as amended by Revenue Act of 1950, Pub. L. No. 81-814, § 210, 64 Stat. 906, 933).

ated such property.²³⁸

To summarize, the Revenue Act of 1950 effectively excluded copyrights, literary, musical or artistic compositions and similar property held by a creator or his donee (or employer) from the definition of "capital assets." In so doing, Congress made sure that the loophole available to amateur authors no longer existed so that both amateur and professional authors would realize ordinary income upon a sale or exchange of their creations. Congress also plugged the loophole whereby an artist could utilize a collapsible corporation to turn his income into capital gain. And finally, Congress excluded copyrights and other artistic creations from the definition of property used in a trade or business which might be eligible for long-term capital gain treatment.

C. *The Internal Revenue Code of 1954: Sale or Exchange of Patents*

In the general comment to the Internal Revenue Code of 1954,²³⁹ the House report stated that the purpose of the changes in the Code was "to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."²⁴⁰ These modifications in the Code were to act as incentives for economic growth.²⁴¹ The House added that these provisions were important for the survival of small businesses.²⁴²

238. Revenue Act of 1950, Pub. L. No. 81-814, § 210, 64 Stat. 906, 933 (amending Revenue Act of 1942, Pub. L. No. 42-753, § 151(b), 56 Stat. 798, 846 (1942)), *reprinted in* 1950 U.S. CODE CONG. SERVICE 510. For the text of section 117(j), see *supra* note 235.

The Report of the Senate Finance Committee explained that the amendment "excluded copyrights and literary, musical, or artistic compositions, and similar property in the hands of certain taxpayers from . . . the definition of 'property used in a trade or business' which is entitled to the benefits of section 117 . . ." S. REP. NO. 2375, 81st Cong., 2d Sess., 27-28, *reprinted in* 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS: 1953-1939, at 1808 (1954).

239. Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 1 (1954).

240. H.R. REP. NO. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025.

241. *Id.* The Committee Report stated that:

The restrictive effects of the present tax law on economic growth have been obscured and somewhat offset during the past decade by the inflationary pressures of the war and postwar periods. It is now apparent that prompt adoption of this new tax law is especially timely in order to create an environment in which normal incentives can operate to maintain normal economic growth Its passage will lead to increased employment and a higher standard of living.

Id.

242. *Id.* at 4026. The Committee Report specifically explained that:

Thus, to remove inequities and to end harassment, Congress enacted section 1235 to help individual inventors and patentors.²⁴³ The House placed patents under the rubric of certain special types of assets.²⁴⁴ Section 1235 was designed to do away with the “confusing and arbitrary” distinctions between amateur and professional inventors and between royalty payments and fixed sum payments.²⁴⁵ The House stated that the provision was intended to obviate the difficulty of determining whether an inventor had sufficient prior inventions to qualify it as a sale in the ordinary course of business.²⁴⁶ Furthermore, according to the House interpretation, an amateur inventor who transferred his patent or invention in exchange for royalty payments would realize only ordinary income before the 1954 Act, whereas an amateur inventor who transferred his patent for a fixed sum realized long-term capital gain.²⁴⁷ As a result, under section 1235, both

The bill contains many provisions which are important to the growth and survival of small business. These include more adequate depreciation, a more realistic policy with respect to retained earnings, more liberal provision for research and development expenditures, a stimulus to equity financing through dividend relief, recognition of business practices for tax accounting purposes, and simplified procedures for partnerships and corporate reorganizations.

Id.

243. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 1235, 68A Stat. 1, 329-30. For the text of section 1235, see *supra* note 6.

244. See H.R. REP. NO. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4025, 4108.

245. *Id.*

246. *Id.* at 4422. The committee further explained that:

Under existing law, only amateur as distinct from professional inventors can obtain capital gain treatment; and, to make this distinction, it has become necessary to determine whether sufficient prior inventions exist to warrant placing the taxpayer in the business of selling inventions to customers, a requirement that has in many instances caused confusion and litigation. To alleviate this difficulty in the case of gain, and to provide a larger incentive to all inventors to contribute to the welfare of the nation, this section is applicable equally to all inventors, whether amateur or professional, regardless how often they sell their patents. . . .

Id.

247. *Id.* The Committee Report stated that:

Under present law an amateur inventor may receive capital gains treatment on the outright sale of his patent but a professional may not. However, if a sale arrangement results in royalty income, rather than installment payments, even an amateur inventor receives ordinary income tax treatment.

The present distinction between amateur and professional inventors and between royalty income and installment payments is both arbitrary and confusing. Moreover, the present treatment tends to discourage scientific work.

Id. at 4108.

amateur and professional inventors were given the preference of being able to realize long-term capital gain upon the transfer of their inventions whether they received royalty or fixed sum payments.

The Senate Finance Committee's revision of the House bill inserted a provision that eliminated the need for any holding period upon a transfer of property. This provision stated "that a transfer . . . of all substantial rights evidenced by a patent . . . shall be deemed a sale or exchange of a capital asset held for more than six months" ²⁴⁸ The Senate Finance Committee also added that an assignment or exclusive license of the patent would be deemed to constitute a "sale or exchange" for tax purposes. ²⁴⁹ In further clarifying which taxpayers were entitled to the benefits of this provision, the Finance Committee said that the section was limited to "holders" who were individuals "whose efforts created the patent property transferred, by which is meant the 'first and original' inventor" ²⁵⁰

So, to do away with the confusing and arbitrary distinctions

248. S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5082. The Finance Committee explained that this six month holding period would be applied "regardless of whether or not payments in consideration of such transfer are payable periodically over a period generally coterminous with the transferee's use of the patent or are contingent on the productivity, use, or disposition of the property transferred." *Id.* In 1954, six months was the holding period necessary in order for a taxpayer to realize capital gain in the transfer of a capital asset.

249. *Id.* In elaborating on its decision to treat an assignment or exclusive license as a sale or exchange, the Finance Committee stated that:

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent . . . should be transferred to the transferee for consideration [E]xclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be 'sales or exchanges' because, in substantive effect, all 'right, title, and interest' in the patent property is transferred.

Id. at 5082-83.

250. *Id.* at 5083. The Finance Committee further explained that it was: desirous of extending the scope of this section to cover (in addition to inventors) those individuals who contribute financially toward the development of the invention. Accordingly, paragraph (2) of subsection (b) also includes within the definition of 'holder' any other individual who acquired his interest in such property in exchange for consideration in money or money's worth (i.e., consideration capable of present valuation in monetary terms) actually paid to the creator prior to the time when the invention (to which the patent rights relate) is actually reduced to practice

Id. The definition of "holder," however, was not to apply to "any individual who is either an employer of any creator or related to any such creator" *Id.* For the complete text of section 1235, see *supra* note 6.

between amateur and professional inventors, Congress enacted a provision which gives the preferential treatment of long-term capital gain to the amateur inventor who receives a fixed sum payment as well as to the amateur inventor who receives royalty payments.²⁵¹ Furthermore, because the distinction between an amateur inventor and a professional inventor was confusing, Congress included them both within the definition of a "holder" entitled to the benefits of section 1235.²⁵² Finally, to make certain that there was enough of an incentive, Congress eliminated the need for any holding period.²⁵³ It is interesting that in the legislative history to the Revenue Act of 1950, Congress stated that the policy behind the enactment of section 1221(3) was to exclude from the definition of a capital asset those creations which were the result of *personal efforts*.²⁵⁴ Furthermore, to do away with the confusing distinction between an amateur author and a professional author, Congress, in 1950, denied the preferential treatment to both. And to insure that the creator (first and original author) of the copyrighted property could not realize any capital gain on a sale or exchange or even on involuntary conversion of his creations, Congress excluded copyrights held by their creators from the definition of property used in a trade or business. Yet, in the face of these curtailments, Congress, in 1954, enacted a statute which gives the inventor the very preferences it has denied the author.

IV. WHY SUCH TREATMENT?

A. *Congressional Power to Issue Copyrights and Patents Arises From Same Constitutional Grant*

Congress derives its power to enact laws to benefit the sciences and the arts from one clause in the Constitution: "[Congress shall enact laws] to promote the Progress of Science and Useful Arts, by securing for a limited time to Authors and Inven-

251. For a discussion of the prior tax treatment of amateurs who received royalty or fixed sum payments for their patents, see *supra* notes 128-34 and accompanying text.

252. For a discussion of the policy of the Revenue Act of 1950 in excluding from the definition of capital assets creations resulting from one's personal efforts, see *supra* notes 212-13 and accompanying text.

253. For a discussion of the necessity for a holding period for capital assets, see the statements of Senator Walsh, *supra* note 204 and accompanying text.

254. For a discussion of the policy of the Revenue Act of 1950 in excluding from the definition of capital assets creations resulting from one's personal efforts, see *supra* notes 212-13 and accompanying text.

tors the exclusive Right to their respective Writings and Discoveries.”²⁵⁵ But Congress, through its policies, has given only inventors the preferential treatment of long-term capital gain upon an exchange of their inventions. Under the guise of another policy (“loophole closing measures”), it denies this preferential treatment to authors. Thus, it profits the author little to hold the exclusive right to his writings which Congress grants him, when an unfair share of the proceeds of that exclusive right are taxed out of his hands as soon as he receives them.²⁵⁶

B. *Both Patents and Copyrights Result from Personal Efforts of Creator*

A major discrimination in the Tax Code derives from the distinction which Congress draws between the “personal efforts” of an author and the “efforts” of a holder of an invention. This distinction is of minimal import since both patents and copyrights are the result of the personal efforts of their creators. Yet, only the inventor receives capital gain treatment under the Code. Congress stated that section 1235 was enacted as an incentive to inventors to contribute to the national welfare.²⁵⁷ If contribution to the national welfare was a significant policy consideration, then how can Congress justifiably deprive creators of art, literature and music of the benefits it bestowed upon inventors?²⁵⁸

255. U.S. CONST. art. I, § 8, cl. 8.

256. Pilpel, *Development in the Tax Law*, *supra* note 60, at 271. Ms. Pilpel notes that there is no justification for the discrepancy in tax treatment of copyrights and patents particularly in light of the fact that the founding fathers considered patents and copyrights to be in the same category. *Id.* at 276. The author goes on to question the judgment behind offering incentives to create to inventors but not to authors. *Id.* She concludes that in society’s rush toward increased scientific knowledge, perhaps society has come to “value things more than words, gadgets more than concepts.” *Id.*

257. S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4629, 5082. This legislative history states in part that “prompt adoption of this new tax law is especially timely in order to create an environment in which normal incentives can operate to maintain normal economic growth.” *Id.* at 4629. Section 1235 is also discussed in detail. *See id.* at 5081-84.

The House Report also discusses section 1235. *See* H.R. REP. NO. 1337, 83rd Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025, 4421-24. The report notes that section 1235 is meant “to provide a larger incentive to all inventors to contribute to the welfare of the nation . . .” *Id.* at 4422.

258. *See* Eulenberg, *supra* note 60. Professor Eulenberg discusses the history of capital gains treatment and its tax consequences. *Id.* at 1174. He then notes the specific exclusion of copyrights from the definition of capital assets and the granting of capital characterization to patents. *Id.* at 1175-76. The author notes that while the House Ways and Means Committee proposed to exclude both copyrights and patents from the definition of capital assets, the Senate chose to exclude only copyrights. *Id.* at 1176. The author suggests that

C. *Differences in Tax Treatment Due to Ad Hoc Reactions to Political and Economic Events*

One commentator has suggested that the differences in the tax treatment of copyrights and patents are the result of legislation based on ad hoc reactions to political and economic events, rather than attempts to establish a consistent tax structure.²⁵⁹ For example, before the Revenue Act of 1950, General Eisenhower sold a book for one million dollars which he authored and published, called *Crusades in Europe*. As an amateur author, he was taxed on his profit realized as long-term capital gain. Congress disapproved of this treatment, and reacted by excluding copyrights held by their creators from the definition of capital assets.²⁶⁰ This amendment had the widespread result of depriving professional and amateur authors of the opportunity to recognize long-term capital gain upon a sale of their works.

When Congress was in the process of amending this part of the Code, inventors were also threatened by the same bill that would have excluded patents as well as copyrights from the definition of capital assets. But the inventors were represented at the Senate hearings by lobbyists who successfully crusaded against the proposed exclusion of patents.²⁶¹ Since the lobbying efforts of those helping the artists did not focus on the same aspects of the proposed bills, discriminatory treatment resulted.

Additional support for the proposition that ad hoc reaction caused such disparity is Congress' policy to foster inventions through tax incentives.²⁶² This policy, as expressed in section 117(a)(1)(C) of the 1939 Code, the predecessor of section 1221(2), mandates ordinary income treatment for the creator. However, Congress' policy of using tax incentives to foster inventions has not been proven to materially increase inventive output. The fluctuations in inventive output have, in fact, been interpreted to show no correlation to the changes in tax treatment.²⁶³

there is no rationale for this distinction and criticizes Congress for being "more solicitous of the inventor of a gadget than the author of a book, however profound and influential the book may be." *Id.* at 1173.

259. Note, *supra* note 24, at 1423.

260. See Pilpel, *Development in the Tax Law*, *supra* note 60, at 272. For a further discussion of the "Eisenhower amendment," see *supra* note 207.

261. For a further discussion of the Senate hearings, see *supra* notes 222-29.

262. This policy, of course, contradicts Congress' attitude towards the personal efforts of the creator of property.

263. Note, *supra* note 24, at 1424 n.41. The author states:

At the House hearings in 1953, the patent interests submitted a

D. *Contrivances Needed by Holders of Copyrighted Property to Get Long-term Capital Gain Treatment*

To combat the discriminatory provisions in the Internal Revenue Code, artists and authors are forced to resort to contrivances such as contract rights and corporate formations in order to obtain capital gain treatment upon a transfer of their work. These contrivances evidence a need for eradicating the discriminatory treatment.

In general, courts have denied capital gain treatment for the sale of contract rights to receive money if a taxpayer has no expectation of profit from appreciation in his or her investment.²⁶⁴ The taxpayer must hold the property himself. The right to share in the profit of another person's property is not a capital asset.²⁶⁵

In the *Ferrer* case,²⁶⁶ however, the court was willing to give capital gain treatment to a sale of contract rights. The significance of the *Ferrer* case was the court's willingness to fragment the various rights Ferrer held in the contract between the author and

graph showing fluctuations in the number of patent applications from 1900 to 1950, and contended that the decline in applications from approximately 8.7 per 10,000 population in 1921 to 4.4 in 1949 could be remedied by more favorable tax treatment. Hearings on a *General Revision Before the House Committee on Ways and Means, 83rd Cong., 1st Sess.*, (1953). But this contention is *not* supported by the graph. Between 1917 and 1921 applications increased from 5.9 to 8.7 per 10,000 although tax rates rose sharply over prior years. A decrease in applications after 1921 paralleled a decline in ordinary rates and the introduction of capital gain taxation. And between 1943 and 1946, when both ordinary and capital gain rates had been increased, applications rose from 3.3 to 5.5.

Id. (citations omitted).

264. See *Utilities & Indust. Corp. v. Commissioner*, 41 T.C. 888 (1964) (denying capital gains treatment on sales of certain contract rights to receive money because taxpayer had no expectation of profit from appreciation in value), *modified*, *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965); *Hallcraft Homes, Inc. v. Commissioner*, 40 T.C. 199 (1963), *aff'd*, 336 F.2d 701 (9th Cir. 1964) (denying capital gain treatment on lump sum payment received by taxpayer for sale of right to receive future income); see also Eustice, *supra* note 63, at 15. Professor Eustice noted that contract rights include only a potential for income, contingent on the future profitability of the object of the rights and thus subject to substantial economic risks of appreciation or depreciation. *Id.* Thus, presumably, there is no expectation of profit. He further noted that "the nature of the interest sold . . . controlled the capital gain issue." *Id.* at 15-16. He concluded that the *Ferrer* decision represented a sound and significant departure from prior law. *Id.* at 34.

265. See Eustice, *supra* note 63, at 17 ("The sale of a right to earn future ordinary income . . . would seem to be taxable as ordinary income under the spirit, if not the letter of the *Ferrer* tests").

266. For a further discussion of the *Ferrer* case, see *supra* notes 87-103, 139-44 & 151-53 and accompanying text.

himself. If the court had not done so, the fact that this contract provided Ferrer with a right to a contingent royalty interest of future profits could have disqualified the entire contract from the capital asset category under the doctrine of assignment of income, or, because the contingent royalty could instead be considered as deferred compensation. In fact, after fragmenting the contract rights, the only right which the court did not recognize as producing long-term capital gain was precisely the contingent royalty interest in any consideration received by the author for a sale of his retained film rights. This was taxed to Ferrer as ordinary income.

Futhermore, in *Benny v. Commissioner*,²⁶⁷ the taxpayer, through a network of contracts, was able to sell his sixty percent interest of the shares in a corporation which managed his television show and realize long-term capital gain.²⁶⁸ The issue in *Benny* was whether any part of the amount realized was compensation to be taxed as ordinary income. Benny was careful to arrange separate contracts. One contract was with the American Tobacco Company for Benny's personal services, and a second contract was between Benny's corporation (Amusement) and American Tobacco which stipulated that Amusement would manage the Jack Benny Show for American Tobacco. When Benny sold his stock in Amusement, he successfully argued that the amount realized was long-term capital gain because he personally held the contract with American tobacco for his personal services. The Amusement Corporation, on the other hand, held the management contract which was its primary asset.

The Tax Court in *Benny* held that all the evidence established "beyond doubt that the substance of the transaction in question was accurately and completely reflected by the form in which it occurred."²⁶⁹ The court stated that the amount paid to Benny was for stock in a "bona fide corporation." Therefore, the sale of that stock was the sale of a capital asset which resulted in long-term capital gain treatment.

In a 1982 Private Ruling,²⁷⁰ the Service also stated that a royalty contract, received in exchange for an exclusive license to publish a non-fiction book, was income-producing property. This

267. *Benny v. Commissioner*, 25 T.C. 197 (1955).

268. *Id.* at 198.

269. *Id.* at 208.

270. Private Ruling 8217037, *supra* note 85. For a further discussion of Private Ruling 8217037, see *supra* note 86 and accompanying text.

contract could be transferred to trusts created to benefit the minor children of an author. The tax would then be shifted to the trust. This Private Ruling indicates a willingness by the Service to treat as property, royalty contracts received as consideration for income-producing property.

Artists also circumvent some of the Tax Code's discriminatory treatment by forming corporations. The corporate form of doing business is a popular method of deferring and reducing the tax burdens of popular entertainers.²⁷¹ The *Benny* case suggests not only that artists may successfully establish contract rights, but also that a corporation formed by a performing artist can be recognized by the courts as a bona fide corporation.²⁷²

A more recent case, *The Estate of Nathaniel (Nat King) Cole*,²⁷³ reinforces the decision of the *Benny* court. The *Cole* case dealt with an artist who did business as a corporation. The artist transferred to the corporation his previously created property.²⁷⁴ The corporation then served as a means for the disposition of that property.²⁷⁵ The artist, as an employee of the corporation, also received a salary from the corporation for his services of creating property during his employment.²⁷⁶ Thus, the benefit for the artist was twofold: it was a vehicle for the disposition of previously created property and it was an employer.²⁷⁷

Cole transferred to the corporation his rights to receive royalties from the use of previously made master recordings,²⁷⁸ and he also agreed to make new recordings for the corporation.²⁷⁹

271. Beghe, *supra* note 83, at 509. Mr. Beghe notes the advantages for the artist of the corporate form, including the opportunity to even out irregular personal income by regular salary payments. *Id.* at 510. He notes, however, that the Commissioner has launched various attacks on this type of closely held corporation. *Id.* at 511; see also Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX'N 88 (1970). While Mr. Beghe notes some drawbacks to the corporate form, e.g., the expense, he concludes that its use deserves serious consideration by the artist. Beghe, *supra*, at 514.

272. *Benny v. Commissioner*, 25 T.C. 197, 210 (1955). See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (3d ed. 1971); 17, 17A and 17B; EATON, *BUSINESS ORGANIZATIONS, PROFESSIONAL CORPORATIONS AND ASSOCIATIONS* (1970); Bertrams, *Tax Problems of the Straw Corporation*, 20 VILL. L. REV. 735 (1974). For a further discussion of *Benny*, see *supra* notes 51-59 and accompanying text.

273. *Estate of Cole*, 32 T.C.M. (CCH) 313 (1973).

274. *Id.* at 316.

275. *Id.* at 317.

276. *Id.*

277. Beghe, *supra* note 83, at 513.

278. *Cole*, 32 T.C.M. (CCH) 313, 316-19 (1973).

279. *Id.* at 319.

The Tax Court found that Cole's corporation had acquired income-producing property (the royalty contracts) in an arms length transaction,²⁸⁰ rejecting the Service's attempt to reallocate the income under the assignment of income doctrine.²⁸¹ The *Cole* case is in accord with *Benny* on the issue of whether a corporation set up by a performing artist to hold his contract rights will be recognized by the courts as a bona fide corporation and not as a sham created for tax avoidance.²⁸²

In 1959, the Service issued a Revenue Ruling²⁸³ stating that it would follow the decision of the Tax Court in *Benny*.²⁸⁴ In Revenue Ruling 59-325, the Service identified the issue in *Benny* as whether a part of the amounts received for a sale of property was in fact received as consideration for future services to be rendered to the purchaser by the seller.²⁸⁵ In *Benny*, the Tax Court found that the amounts received were for property transferred (i.e., a sale of stock in a corporation).

Although performers have sometimes succeeded in forming corporations in order to realize capital gains, the Service has warned that it will carefully scrutinize any arrangement which appears to be a sale of personal services in the guise of a sale of a capital asset to determine whether the substance of the arrangement is a scheme for the avoidance of income tax. Furthermore, whether the visual artist, as opposed to a performer, can, by form-

280. *Id.* at 324-25.

281. *Id.* at 325.

282. *Accord Marx v. Commissioner*, 29 T.C. 88 (1957). The *Marx* case concerned gains received on the sale of an interest in a partnership. *Id.* at 89. The Service contended that a portion of the gain was compensation for service and thus taxable as ordinary income. *Id.* at 99. The court disagreed, noting that this was an arms-length sale for fair market value. *Id.* at 100. Thus, the court held that the amount realized was taxable as capital gain. *Id.* at 101; *see also Commissioner v. O'Brien*, 25 T.C. 376 (1955). In *O'Brien*, the court considered whether the gain realized on the liquidation of a "collapsible" corporation is capital gain or ordinary income and concluded that it was the former. *Id.* at 383. While the court found the taxpayer's corporation to be collapsible, it also noted that such corporate forms were widely used in the motion picture industry. *Id.* The court concluded that the circumstances surrounding the enactment of a provision concerning collapsible corporations (117(m) of the 1939 Code) left the courts free to determine whether liquidation of such corporations resulted in capital gain or ordinary income. *Id.* at 382-83. For a discussion of the enactment of section 117(m) of the 1939 Code, *see supra* notes 229-31 and accompanying text.

283. Rev. Rul. 59-325, 1959-2 C.B. 185.

284. In Rev. Rul. 59-325, the Service also indicated that it would follow the Tax Court's decision in *Marx*. For a discussion of the *Marx* case, *see supra* note 281. While noting its willingness to follow the *Benny* and *Marx* decisions, the Service cautioned that it would carefully scrutinize any arrangement which appeared to be a tax avoidance scheme. Rev. Rul. 59-325, 1959-2 C.B. 185.

285. *Id.* Rev. Rul. 59-235, 1959-2 C.B. 186.

ing a corporation to which he transfers his created works, realize long-term capital gain upon the sale of his shares in such a corporation, has not yet been tested in court.²⁸⁶ One commentator has suggested that the successful visual artist might use a corporation as a vehicle for the disposition of his current work and works which he previously created and transferred to the corporation.²⁸⁷ Although this corporation could be deemed a collapsible corporation under I.R.C. § 341,²⁸⁸ the artist might be able to gain tax advantages because of section 341(b)(3) which states that collapsible treatment does not apply to gain realized from the sale of an item of property more than three years after the production of that property is completed.²⁸⁹ Therefore, if the product is completed and transferred to the corporation three years prior to the

286. At least one visual artist has formed a corporation, presumably for purposes of realizing long-term capital gains for his works. See Monroe, *Prime Property: Besides Being an Artist, Christo is Main Asset Claimed by CCJ Corp.*, Wall St. J., July 12, 1984, at 1, col. 1.

Christo v. Javacheff is an artist noted for doing "[u]nsung things in unusual places." *Id.* For example, in a work that was called "running fences" he stretched an eighteen foot high fence of woven nylon fabric, steel poles and cables through the hill country of two California counties *Id.* In another project named "Surrounded Islands," he "surrounded eleven islands in Florida's Biscayne Bay with 6.4 million square feet of bright pink erosion control fabric" *Id.*

The projects are expensive undertakings, and Christo and his wife formed C.V.J. Corp. in 1971 to finance the projects. *Id.* C.V.J. pays Christo a salary for his paintings and collages. C.V.J. then sells the paintings and collages to art museums, private collectors and dealers. *Id.* The proceeds from such sales are then used to finance Christo's more expensive projects. *Id.*

287. Beghe, *supra* note 83, at 510.

288. I.R.C. § 341 (1982). Section 341 provides, in pertinent part: [T]he term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which . . . is property [held] . . . with a view to—

(A) the sale or exchange of stock by its shareholders . . . or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property.

Id. § 341(b)(1).

Mr. Beghe notes that the artist could time his transactions with the corporation to avoid collapsible treatment. Beghe, *supra* note 83, at 510. He cautions, however, that such a device would be attacked by the Service. *Id.* at 510, n.88; see also *Hollywood Baseball Ass'n v. Commissioner*, 42 T.C. 234 (1964) (corporation set up to acquire a professional baseball team; collapsible corporation argument not asserted against selling shareholders on liquidation of corporation), *aff'd*, 352 F.2d 358 (9th Cir. 1965), *vacated*, 383 U.S. 824 (1966).

289. I.R.C. § 341(b)(3) (1982).

sale of stock, the artist should be able to realize capital gain upon the sale of his shares.

However, despite the fact that such a corporation would not be treated as collapsible, the Internal Revenue Service can still attack corporations formed by artists. The Service can argue that the corporate entity is a sham, that the corporation lacks corporate attributes; that the corporation is a personal holding company; that the corporation is an agent for the artist; or that *Corn Products* applies because the stock is a business asset of the artist.²⁹⁰

The fact that artists resort to the transfer of contract rights and to the costly and risky corporate form of doing business²⁹¹ indicates their need to protect themselves from the heavy tax burdens inflicted upon them.²⁹² Treatment of copyrights as capital assets would alleviate those burdens.

Inventors, on the other hand, do not worry about contrivances such as the creation of contract rights or the formation of corporations because of the benefits of section 1235. Section 1235 recognizes patent licensing as a sale. In the case of a fixed sale of an invention, the section declares the invention to be a capital asset. If the inventor cannot qualify under section 1235, he can look to section 1231 for possible capital characterization. And finally, the transfer of a patent license in exchange for contingent payments also produces long-term capital gain under section 1235 as long as all substantial rights to the patent or an undivided interest in the patent are transferred.²⁹³

Even a transfer of know-how gets the benefit of long-term

290. For an in depth discussion of the corporate form of doing business, see Beghe, *supra* note 83. For a further discussion of *Corn Products*, see *supra* note 165 and accompanying text.

291. The corporate form does provide the traditional tax benefits of income deferral, medical reimbursement, group life insurance, and other perks. However, the artist whose corporation performs most of its services for only one person runs the risk that the corporation may not be recognized for tax purposes. See Cutrow, *supra* note 86, at 393-94.

In addition, because of the changing fiscal environment, the corporate form is no longer essential in order to receive certain benefits which previously were available only to corporations. For example, a change from the previous law no longer requires incorporation in order for a taxpayer to receive the benefit of qualified employee plans. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982), Cutrow, *supra* note 86, at 393-94.

292. See Monroe, *supra* note 285.

293. For a detailed discussion of patent licensing, see Morreale, *supra* note 46, at 555.

capital gain treatment.²⁹⁴ Revenue Ruling 71-564 treats a fixed price sale of know-how as property qualifying as a capital asset under section 1221.²⁹⁵ In addition, exchanging a license for know-how, like a patent license, will produce capital gain if all substantial rights have been transferred.²⁹⁶ Furthermore, the creators of know-how qualify for research and experimental expense deductions under section 174.²⁹⁷

E. *Tax Risks in Seeking Classification*

In light of the Tax Code's gross discrimination against the creators of copyrightable property and its tremendously preferential treatment towards creators of patentable property and inventions, one must closely scrutinize the distinction between that which is copyrightable and that which is patentable, or at least that which categorically falls within section 1235.²⁹⁸ If a taxpayer

294. See generally Cohen, *supra* note 46; Harding, *supra* note 46; Morreale, *supra* note 46, at 566.

295. Rev. Rul. 71-564, 1971-2 C.B. 179. The ruling noted that the similarity of secret know-how and patents warranted similar treatment. *Id.* The Service cautioned that in order to qualify for capital treatment, the transfer of know-how must be an unqualified transfer of all rights until the secret information becomes public. *Id.* at 180.

296. See, e.g., *Pickren v. United States*, 378 F.2d 595 (5th Cir. 1967). In *Pickren*, the taxpayer retained an absolute one-half interest in the know-how that he transferred. *Id.* The *Pickren* court noted the similarity of patents and know-how. *Id.* at 599. After looking at the contract of transference, the court concluded that the parties did not intend a transfer of all the taxpayer's rights in the know-how and that the income from the transfer was ordinary income. *Id.* at 601. The court noted that a transfer of all substantial rights would have received capital treatment. *Id.* at 599.

297. See Morreale, *supra* note 46, at 564. Treasury Regulation § 1.174-2(a)(1) provides definitions of research and experimental expenditures. Treas. Reg. § 1.174-2(a)(1) (1960). The term 'research or experimental expenditure,' as used in section 174, means expenditure incurred in connection:

with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. However, the term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. On the other hand, the term does not include the costs of acquiring another's patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

Id.

298. See generally La Rue, *Some Comparisons Between Copyright, Patent, Trade Se-*

can classify his creation as an invention or design, he may qualify for the benefits of section 1235.

From a non-tax perspective, because patents take more time to issue than copyrights thus delaying protection from infringement to an inventor, it is often more advantageous to try to qualify a work as one which is protected by copyright. This is especially true in the relatively new area of computer programs which, due to their transitory nature, need immediate protection. As a result of 1980 amendments to The Copyright Act of 1976 which specifically encompass computer programs,²⁹⁹ there is much confusion as to what is "new and useful as embodied in the

cret and Trademark Law, in *LAW AND THE VISUAL ARTS*. 147 (1974). Professor La Rue finds no distinction which would justify the preferential treatment of patents and not copyrights. *Id.*

A patent protects a tangible invention or discovery which embodies any new and useful process, machine, manufacture or composition of matter, or any new and useful improvement. The criteria for a patent to issue are novelty, utility and nonobviousness. Once issued, the patent lasts for 17 years, which enables the inventor to exclude all others from making and using the invention even if independently discovered. The patent application must be filed within one year from public disclosure of the invention to protect it. Infringement is proved by showing substantial similarity. 35 U.S.C. § 101 (1982).

The requirements of the Copyright Act of 1976, on the other hand, require that the work be "fixed" in a tangible medium and that it have "originality of authorship." A copyright protects the creator against another's copying the work. But another person can independently create a similar or even identical work. Copyright protection is obtained by placing a notice of copyright, the name of the owner of the copyright, and the date on the work itself. Registration is necessary only as a prerequisite to a lawsuit, but if registered, the duration of the copyright is the life of the creator plus fifty years. Further, in the copyright area, it is necessary to distinguish the physical object which embodies the expression from the copyright which remains with the creator. If stipulated in writing, the copyright itself may be purchased with the work. Infringement is proved by establishing both substantial similarity and copying. 17 U.S.C. § 501 (1982).

The primary factor which distinguishes patentability from copyrightability is the requirement of novelty in order to obtain a patent. The standard of novelty is best delineated by the Supreme Court of the United States' decision in *Graham v. John Deere Co.*, 383 U.S. 1, 6 (1966). In *Graham*, the Court stated that "innovation, advancement and things which add to the sum of useful knowledge are inherent requisites in a patent system . . . which by constitutional commandment must 'Promote the Progress of the Useful Arts.'" *Id.* For a discussion of *Graham*, see 1 M.B. NIMMER, *supra* note 2, § 2.01[A] n.10; see also Falk & Woodbridge, *Taxation of the Development and Sale of Patents, Trade Secrets and Copyrights*, N.J. LAW. 39 (1985) (comparing tax treatments).

Copyrights, on the other hand, require originality, which is defined by Professor Nimmer to mean "independent creation," and not copied by others. 1 N.B. NIMMER, *supra*, § 2.01[A].

299. 17 U.S.C. § 101 (1976), amended by Pub. L. No. 96-517 § 10(a), 94 Stat. 3015, 3028 (1978). The Copyright Act of 1976 was amended by the Computer Software Act of 1980, in accordance with the recommendations of CONTU (The National Commission on New Technological Uses of Copyrighted Works). According to the definitional section of the Act, a "computer program"

process, machine, manufacture, or composition of matter," and hence patentable,³⁰⁰ and what is an expression of an idea, and therefore copyrightable.³⁰¹ A close reading of the district court and the court of appeals decisions in a recent computer case illustrates the judiciary's confusion about the utility-expression dichotomy.³⁰² The fact that the courts have no clear concept of the

is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result." *Id.*

300. See 35 U.S.C. § 101 (1982). Section 101 provides: "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title." *Id.*

301. See 17 U.S.C. § 102(a) (1976). The subject matter of a copyright is delineated in this section. Section 102(b) goes on to enumerate that which is not subjected to copyright. According to section 102(b), copyright protection does not extend to an original work of authorship of "any idea, procedure, process, system, method of operation, concept, principle or discovery regardless of the form in which it is described, explained, illustrated, or embodied in such work." *Id.* § 102(b). For the text of § 102, see *supra* note 89.

The expression/utility dichotomy inherent in the distinction between copyrights and patents was first discussed in *Baker v. Selden*, 101 U.S. 99 (1879). The *Baker* Court stated that:

The description of the art in a book, though entitled to the benefit of copyright, lays no foundation for an exclusive claim to the art itself. The object of the one is explanation; the object of the other is use. The former may be secured by copyright. The latter can only be secured, if it can be secured at all, by letters-patent.

Id. at 105; accord *Taylor Instrument Cos. v. Fawley-Brost Co.*, 139 F.2d 98 (7th Cir. 1943) (chart used in recording industry not copyrightable), *cert. denied*, 321 U.S. 785 (1944).

302. *Apple Computer, Inc. v. Franklin Computer Corp.*, 545 F. Supp. 812 (E.D. Pa. 1982), *rev'd*, 714 F.2d 1240 (3d Cir. 1983), *cert. dismissed*, 464 U.S. 1033 (1984). In *Apple*, Apple Computer brought suit seeking an injunction to restrain Franklin from using, copying, selling, or infringing Apple's registered copyrights on fourteen computer programs. 714 F.2d at 1244. The programs were expressed in object code which is designed to be read by the machine. *Id.* at 1243. Apple charged that Franklin had stolen the logic and structure of their systems. *Id.* at 1244.

The district court stated that Apple had failed to distinguish the form of the work from its utilitarian purpose—the function and the form were merged because each work as a whole conveys information. 545 F. Supp. at 812, 823. The court acknowledged that courts and commentators are divided on the treatment of object codes, and noted that Apple's position was not "implausible." *Id.* at 818 n.8. However, the district court concluded that there was some doubt as to the copyrightability of the computer programs at issue and denied Apple's request for a preliminary injunction. *Id.* at 812.

On appeal, the Third Circuit reversed and remanded the case. 714 F.2d at 1255. Although acknowledging the judicial confusion, the court said: "We believe that in the context before us, a program for an operating system, the line must be a pragmatic one, which also keeps in consideration 'the preservation of the balance between competition and protection reflected in the patent and copyright laws.'" *Id.* at 1253 (quoting *Herbert Rosenthal Jewelry Corp. v. Kalpalsian*, 446 F.2d 738, 742 (9th Cir. 1971)). If the idea merges with the expression so that the two are inseparable, then the expression may not be pro-

distinction between patentability and copyrightability reinforces the conclusion that both are closely related. Yet, a creator's inability to qualify his creation as an invention or useful design can result in significant tax burdens.³⁰³

V. POSSIBLE SOLUTIONS TO THE I.R.C. SECTION 1235 INEQUITY

As indicated earlier in this article, a statement was made at the Senate hearings on the Revenue Revision Act of 1950 which noted that the proposed legislation to exclude both patents and copyrights from the definition of a capital asset was "discriminatory and arbitrary, and a great discouragement to the creative genius of the United States."³⁰⁴ Congress, by enacting a provision which excluded only copyrights held by their creators from the definition of capital assets, acted in an even more discriminatory and arbitrary fashion.

Congress was able to delete "patents, designs, and inventions" from its proposed bill³⁰⁵ because of its policy of fostering inventions.³⁰⁶ But this policy should not be enough of a justification to give patents preferential treatment while denying it to copyrights. This is especially apparent when one examines the irrationality of the classifications as delineated by Congress. Both patents and copyrights are the result of the personal efforts of their creator. Both advance the interest of mankind, one in the area of the sciences and the other in the area of the arts. Both benefit society; one perhaps by promoting life and the other by making it more pleasurable to endure. Most significantly, both

tected by copyright. *Id.* The court held that if the idea of Apple's operating program could be expressed in other various modes, then there was no merger and Apple could protect its mode of expression with a copyright. *Id.* The court also said that Apple sought only to protect by copyright the instructions imbedded in the object program and not the method which instructs the computer to perform it. *Id.*

303. It is significant to note that both parties to the *Apple Computer* cases were corporations. 714 F.2d at 1240. Because "holders" under section 1235 can only be individuals, corporations are excluded from the benefit of section 1235. See I.R.C. § 1235(b)(1), (2) (1982). Therefore, there is little incentive for corporations to seek patent protection, especially if copyright law can protect them as soon as the product comes into being and notice of copyright is affixed to the product. For the full text of section 1235, see *supra* note 6.

304. For a discussion of the statement, see *supra* note 215 and accompanying text. See also S. WELL, *BEAUTY AND THE BEAST* (1983) (suggesting that Internal Revenue Code is "indifferent to the quality of art").

305. For a discussion of the deletion, see *supra* note 231 and accompanying text.

306. For a discussion of Congress' policy, see *supra* note 231 and accompanying text.

the courts³⁰⁷ and the Internal Revenue Service (as recently as 1984) have acknowledged the substantial similarity between the two classes of property.³⁰⁸ Moreover, the enactment of a proposal whereby copyrighted property held by its creator would be treated as a capital asset would clear away the uncertainties which abound in the Tax Code for the artist.³⁰⁹ While the artist, under the present tax structure, can be certain that, while in his own hands, his creation is not a capital asset, he is left to ponder whether the transfer of that asset is a sale, a right to future income, or compensation.³¹⁰ He must also ponder whether he has earned income or, instead, has transferred a piece of property which does not yield him the classification of earned income.³¹¹ Furthermore, artists of other countries are entitled to a complete or partial exemption from income tax.³¹² The tax laws of Ireland with respect to artists serve as a good example. In Ireland, the work of painters, sculptors, writers and composers (but not performing artists) is exempt from income tax if the work is found to be "original and creative and of cultural or artistic merit."³¹³ (Remember *Ulysses* by James Joyce). Congress should again be faced with proposed legislation which would entitle artists to the same capital gain treatment already given to inventors.

One commentator has suggested another possible solution which would be to revise section 1235 to allow both inventors and

307. See, e.g., *Apple Computer, Inc. v. Franklin Computer Corp.*, 545 F. Supp. 812 (E.D. Pa. 1982), *rev'd*, 714 F.2d 1240 (3d Cir. 1983), *cert. dismissed*, 464 U.S. 1033 (1984). For a discussion of the *Apple* case, see *supra* notes 301-02 and accompanying text.

308. See G.C.M. 39252, 24 TAX NOTES 362 (1984); Rev. Rul. 60-226, 1960-1 C.B. 26. For a further discussion of G.C.M. 39252, see *supra* notes 125-28 and accompanying text. For a further discussion of Rev. Rul. 60-226, see *supra* note 64 and accompanying text.

309. In the early seventies, friends of the artists proposed legislation similar to section 1235 which would have provided capital gain treatment to authors, artists, composers and their patrons. Congress, unfortunately, did not enact this legislation. See H.R. REP. 696, 93d Cong., 1st Sess., 119 CONG. REC. 1865 (1973).

310. For a discussion of the characterization of such a transfer, see *supra* notes 113-56 and accompanying text.

311. See G.C.M. 39252, 24 TAX NOTES 362 (1984). For a discussion of G.C.M. 39252, see *supra* note 29 and accompanying text.

312. See *Hearings on General Tax Reform Before the House Committee on Ways and Means*, 93d Cong., 1st Sess., 6117 (1973) (*cited in* Beghe, *supra* note 83, at 495) (several countries grant such an exemption).

313. See Bouuaert, *Fiscal Problems of Cultural Workers in the States of the European Economic Community*, Commission of the European Community 24 (1977) (as cited in Feld, *supra* note 17, at 16). Bouuaert discusses the tax treatment of artists in Ireland and in other European countries. *Id.*

authors capital gain treatment, but only to the extent of five times the invested capital.³¹⁴ This proposal begins with the premise that since both patents and copyrights result primarily from the personal efforts of the creator rather than from investment of capital, the sale or exchange of either by the creator should be treated as a capital transaction only to the extent of five times the capital invested in the property or half of the gain, whichever is less. This would only apply to amateurs. I.R.C. section 1221(3) would be repealed.

However, this proposal's failure to distinguish "amateur" from "professional" artists lessens its appeal. Furthermore, the adjusted basis in the property would be withdrawn from the amount realized before the creator is required to pay taxes on any gain. The inventor would still have a significant edge over the author, as the inventor's higher adjusted basis would entitle him to a larger capital gain. The inventor would still be entitled to the section 174 research and experimental expense deduction and to the section 44F research and experimental expense credit. While not a perfect answer, this proposal is certainly more equitable than the present tax.

An argument has also been made for a revision of I.R.C. section 170(e) which provides for deductions for charitable contributions. Such a revision could also apply to either a revision of section 1235 or an amendment of section 1221(3).³¹⁵ Currently, when an author or artist donates a work to a charitable institution, he can deduct only his actual cost. But when a collector donates a work of art, she can deduct both her previously taxed income (i.e., her cost) plus the untaxed appreciation of the gift's value. Congress could correct this inequity by permitting the artist to realize capital gains tax treatment on the appreciation of his work by dividing the gain which the artist realized on the sale of his work into two parts: the value which the artist added to the materials through his personal efforts would be ordinary income; the appreciation of the value of the work from the time of its creation to the time of its disposition would be long-term capital gain.

To apply this appreciation concept generally, Congress need only amend section 1221(3) to provide that, as of the date of completion, the artist must compute the value of his work as increased by his personal efforts. If he then chooses to hold the property as an investment, he would pay the necessary tax on the property,

314. See Note, *supra* note 24, at 1426-27.

315. See Feld, *supra* note 17, at 14-15.

computed as if he had immediately sold the work. A realistic determination of that value could be determined by: 1) the signed and dated notice of copyright, and 2) if need be, by the Internal Revenue Act Advisory Panel.³¹⁶ Hence, the artist would not be able to consider the value of his personal efforts as capital gain upon a sale or exchange of his creation. This is in keeping with Congress' policy announced in 1950.³¹⁷ But, once the fair market value of his piece is determined and the necessary tax paid, the artist should be allowed to hold his own creation as an investment. Then, if he should sell this piece, he would realize long-term capital gain for the amount that represents appreciation. To a certain extent, the artist who places his work on sale does exercise some control over those works which he believes to be of better quality by pricing them higher than his other works. Why should he not be able to treat those better pieces as investments? Furthermore, Congress' policy on appreciation, as expressed when it first enacted the capital gains treatment provisions in 1921, is that appreciation which accumulates over the years should not be taxed as a lump sum in the year of realization.³¹⁸

As a final suggestion to resolve the inequity created by section 1235, Congress could repeal that section altogether. As stated before, both copyrights and patents are the result of the personal efforts of the creator. Congress has said that the personal efforts of an artist should be taxed as ordinary income. Furthermore, prior to the enactment of the Revenue Revision Act of 1950, Congress had discussed the possibility of excluding patents as well as copyrights from the definition of capital assets.³¹⁹ Even with the repeal of section 1235, patents would still be afforded the opportunity of long-term capital gain treatment under section 1231 of the Code. Although Congress has been reluctant to with-

316. The Internal Revenue Act Advisory Panel consists of a ten-person panel of art experts appointed to help the Service determine whether realistic appraisals of fair market value have been placed on the works of art. See Lerner, *supra* note 17. For a detailed discussion of how the panel values the works, see Donoghue, *Art Appraisals and Valuation for Federal Tax Purposes*, in REPRESENTING ARTISTS, COLLECTORS AND DEALERS 207, 212 (1983).

317. For a discussion of Congress' policy, see *supra* notes 203-34 and accompanying text.

318. For a discussion of Congress' policy towards appreciation, see *supra* notes 193-202 and accompanying text.

319. For a discussion of the proposed exclusion of patents and copyrights from the definition of capital assets, see *supra* notes 212-17 and accompanying text.

draw a preference once it has been granted,³²⁰ in light of the Deficit Reduction Act of 1984 and the talk of broadbasing the tax, this might well happen.

VI. CONCLUSION

It is readily apparent that there is a gross inequity in the Internal Revenue Code between the discriminatory treatment given to authors and the preferential one bestowed upon inventors. Congress, in the legislative histories, indicated that its policy towards artists is to take "loophole closing measures."³²¹ As evidence of this, it is only necessary to look at the provisions enacted which exclude artists from the preference of long-term capital gain. On the other hand, Congress' stated policy towards inventors is to foster inventions. Hence, we have sections 1235, 174 and 44F. Yet both of these intellectual properties, inventions and copyrights, are very closely related as mandated in the Constitution, as found by the courts and as acknowledged by the Service. Congress should also acknowledge this close relationship among all of the creative geniuses of our country. The policy should be to spark the creativity of all. Using Eulenberg's imagery, this country needs as many Mozarts as it has mousetraps. Congress is the only branch of government with the power to eradicate this inequitable treatment. Even if it should choose to deny capital gains treatment to both authors and inventors, this will indicate to authors and artists that this country, while not preferring them, at least no longer discriminates against them.

320. For a discussion of Congress' reluctance to withdraw a preference once it has been given, see Blum, *supra* note 6.

321. For a further discussion of Congress' policy of taking "loophole closing measures," as evidenced by the legislative histories, see *supra* notes 211-34 and accompanying text.

